IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, *et al.* Plaintiffs, v. ENRON CORP., an Oregon corporation, *et al.*, Defendants.	CIVIL ACTION NO. H 01-3624 AND CONSOLIDATED CASES

MEMORANDUM IN SUPPORT OF DEFENDANT KEN L. HARRISON'S MOTION TO DISMISS PLAINTIFFS' CONSOLIDATED COMPLAINT FOR VIOLATION OF THE SECURITIES LAWS

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67

TABLE OF CONTENTS

Tonkon Torp LLP
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503-221-1440

Tonkon Torp LLP
888 SW Fifth Avenue, Suite 1600
Portland, Oregon 97204
503-221-1440

TABLE OF AUTHORITIES

CASES

Tonkon Torp LLP
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Portland, Oregon 97204
503-221-1440

STATUTES

RULES

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INTRODUCTION

A careful review of Plaintiffs' Complaint[1] and the public record shows two things about their case. First, despite over six-months of investigation, including unprecedented access to media, government, accounting, and internal Enron sources (including "whistle-blowers"), Plaintiffs cannot plead with sufficient clarity or particularity the massive, wide-ranging fraud they contend occurred at Enron's Houston headquarters from 1998 to 2001.

Second, as this brief explains, **Ken L. Harrison does not belong as a defendant in this case.** Ken L. Harrison ("Harrison") joined Enron's Board of Directors (at times, "the Board") in July 1997, when Enron acquired Portland General Electric Company ("PGE"), the regulated electric utility that Harrison ran until March 2000 in Portland, Oregon. He left the Board after it became clear that Enron had no interest in continuing to run or own that hard-asset utility, but instead would focus on the financial business that Plaintiffs contend was the vehicle of Enron's fraud. While at Enron, Harrison did not serve on a **single** Board committee, much less the Executive, Finance, or Audit Committees, which were responsible for reviewing and approving the financial transactions at the heart of the Complaint. Plaintiffs do not and cannot allege that Harrison as an individual or PGE as a company had any connection to the general misconduct they allege. Instead, they hang their case against Harrison on the fact that he sold a significant amount of Enron stock during the class period. What Plaintiffs (and their purported expert) ignore are the public facts that Harrison only acquired Enron stock and options as a result of Enron's acquisition of PGE in 1997 and only sold significant amounts of Enron stock (while retaining nearly half his holdings) when his Enron stock and options vested shortly after he retired from PGE in March 2000, all more than a year before the restatement of earnings that prompted this lawsuit.

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[1] In the text, we refer collectively to the lead plaintiffs and the separately identified individual plaintiffs, as well as the class and sub-classes they purport to represent, as "the Plaintiffs." We refer to their April 8, 2002 Consolidated Complaint for Violation of the Securities Laws as "the Complaint," which we cite as "Newby Compl."

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In short, the Complaint alleges nothing more than the public facts that Harrison served during the class period as an Enron director (but not on any Board committee) and that he sold a portion of his newly-vested Enron stock upon his retirement from PGE, the regulated, hard-asset utility he ran in Portland, Oregon. As we explain in more detail below, those allegations are not nearly enough to keep him in this case.

ARGUMENT

Although the Complaint is extraordinarily long and complex, it says next to nothing about Harrison. That is why our arguments that the Court should dismiss the claims against Harrison are relatively short and simple. In section I., we explain why the Court should dismiss Plaintiffs' entire Complaint against Harrison for failing to satisfy Federal Rule of Civil Procedure 9(b) ("Rule 9(b)"). We then turn to three of Plaintiffs' individual claims. In section II., we show that the Court should dismiss Plaintiffs' first claim against Harrison for alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 because of Plaintiffs' failure to allege scienter consistent with the PSLRA and their failure to allege controlling person liability under Section 20(a) of the Exchange Act consistent with Rule 9(b).[2] Next, we demonstrate in section III. that the second claim for insider trading under Section 20A of the Exchange Act fails against Harrison because Plaintiffs have no underlying claim against Harrison for a Section 10(b) or Rule 10b-5 violation. Last, in section IV. we explain why Plaintiffs fail to state a cognizable claim against Harrison as a "seller" or "issuer" of covered securities under the fourth claim for a violation of the Texas Securities Act ("TSA").

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[2] As used in this brief, the "Exchange Act" is the Securities Exchange Act of 1934, codified at 15 U.S.C. §§ 78(a), *et seq*. The "Securities Act" is the Securities Act of 1933, codified at 15 U.S.C. §§ 77(a), *et seq*. "Rule 10b-5" refers to the Securities Exchange Commission's Rule 10b-5, and is codified at 17 C.F.R. § 240.10b-5. The "PSLRA" is the Private Securities Litigation Reform Act, codified in relevant part at 15 U.S.C. § 78u-4.

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I. The Court Should Dismiss The Entire Complaint Against Harrison For Failing To Satisfy Rule 9(b).

Plaintiffs have filed a monstrous Complaint encompassing nearly 500 pages and over 1000 paragraphs (some with multiple subparagraphs), divided into 19 subsections (some with multiple subsections), alleging at least six different subclasses, naming at least 80 different defendants, attaching over 100 pages of exhibits (including a declaration from their purported expert), and asserting copyright protection over the entire "creative work," all in an effort to state just four claims for relief. Taken together, the monster they have created is a pleading so prolix and complex that it violates Federal Rule of Civil Procedure 8's requirement of a "short and plain" statement of the case,[3] while at the same time so vague and conclusory that it violates Rule 9(b)'s requirement to plead fraud with particularity. Because we understand that other defendants intend to address comprehensively Plaintiffs' multiple failures to satisfy Rule 9(b) as to Enron and the defendants as a group, we will not burden the Court with a paragraph-by-paragraph attack on the Complaint. Instead, this brief focuses on Plaintiffs' failure to state sufficiently any actionable allegations **against Harrison**. After summarizing what the Complaint does and **does not** say about Harrison, we turn to our discussion of Rule 9(b).

A. The Complaint is nearly devoid of allegations against Harrison.

Harrison's name appears in only 19 of the Complaint's 1,030 paragraphs. The first paragraph introduces him as an "Enron Defendant" to facilitate Plaintiffs' subsequent, improper group pleading. (Newby Compl. ¶ 1.) Three more paragraphs recite his various executive and officer positions with Enron and PGE. (Newby Compl. ¶¶ 83(l), 86, 88.) Six other paragraphs allege his trading before and during the class period. (Newby Compl. ¶¶ 83(l), 84, 401, 402, 415, 416 (incorporating an exhibit that mentions Harrison by name).) Seven more paragraphs allege Harrison's signature-by-proxy of various registration statements and public filings in his

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[3] Because Harrison has joined separately in the Motion of Certain Current and Former Directors to Dismiss and Memorandum in Support Pursuant to Fed. R. Civ. P. 8, we do not repeat our Rule 8 arguments here but incorporate them by this reference.

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capacity as a member of the Board. (Newby Compl. ¶¶ 109, 110, 126, 141, 164, 221, 292.) Finally, Harrison is named as a defendant in four additional paragraphs, one in each Claim for Relief (Newby Compl. ¶¶ 993, 999 (naming Harrison as one of "defendant(s) who sold stock"), 1006, and 1019.)

That is all. The balance of the Complaints' apparent allegations against Harrison are accomplished either by using terms the Complaint expressly defines to include Harrison and various other defendants, such as "Enron Defendants," by using undefined terms which may or may not be intended to include Harrison, such as "top insiders" and "Enron insiders," or even by using just the name "Enron."[4] Nowhere does the Complaint allege facts showing that Harrison **individually** participated in or had **individual** knowledge of **any** of the illicit transactions or accounting that Plaintiffs allege as the basis of their claims. As we demonstrate below, Plaintiff's decision to rely on "group" and "status" pleading without such **individual** allegations is fatal to their claims by virtue of Rule 9(b) as it has been applied after passage of the PSLRA.

Moreover, the limited specific allegations about Harrison in the Complaint, as supplemented by the facts available from the public record, show that Harrison's status as an officer of an Enron subsidiary, a member of Enron's Board, and someone who traded Enron stock during the class period does nothing to connect him to Plaintiff's general allegations of improper conduct.

1. Harrison as officer.

Harrison was a career executive at PGE and became CEO of the company in 1987. (1998 Annual Report, SEC App. Tab 84 at 32.[5]) Harrison continued to run PGE (*see*

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[4] *See, e.g.,* Newby Compl. ¶¶ 1, 23, 33, 83, 84, 88, 89, 90, 136, 188, 215, etc. ("Enron Defendants"); ¶¶ 342, 639, 867 ("top insiders"); ¶¶ 222, 300(b), 339(b), 740 ("Enron insiders"); ¶¶ 300 and *passim* ("Enron").

[5] "SEC App." citations refer to the Master SEC Appendix filed in connection with "Certain Defendants' Joint Brief Relating To Enron's Disclosures." The "Tab" citations are to documents specified in the index to that appendix.

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503-221-1440

Newby Compl. ¶¶ 83(l)) after Enron acquired the company in July 1997 (*see* 1997 Form 10-K, SEC App. Tab 2.)[6] Unlike Enron's other lines of business, PGE was and is an asset-based utility that at all times generated and sold electricity to retail customers. (*See, e.g.,* 1998 Form 10-K, SEC App., Tab 6.) Plaintiffs do not and cannot allege any connection with any of the financial transactions involving the Special Purpose Entities ("SPEs"), "related parties," or international development projects conducted out of Houston that are the subject of so much scrutiny in the press and the Complaint. As a regulated public utility, PGE was and is required to file separate financial statements with the OPUC. Or. Rev. Stat. § 757.120.[7] PGE's rates, and hence its ability to earn a return on investment, have always been regulated by the OPUC. Or. Rev. Stat. § 756.040. Thus, PGE had no opportunity to "test the envelope" of accounting principles, as other sides of the Enron business have been accused of doing. Indeed, Plaintiffs do not allege **any** improper accounting connected with PGE, and the utility remains one of the few Enron subsidiaries that are not part of the pending bankruptcy proceedings. Harrison retired from PGE in March 2000 (Newby Compl. ¶ 83(l)), which followed Enron's decision in 1999 to sell PGE (*see* 1999 Annual Report, p. 48, SEC App. Tab 11).[8]

2. Harrison as Board member.

Harrison also joined Enron's Board in 1997 in connection with the PGE acquisition. (*See* Newby Compl. ¶ 86 (incorrectly showing tenure on Board commencing in 1998); *see also* 1997 Form 10-K, SEC App. Tab 2 at 32 (showing tenure beginning in July, 1997).) Significantly, he never sat on the Audit, Finance, or Executive committees of the Board

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[6] At the same time, he became an Enron "Vice Chair," an officer position he held until July 1999. *See* 1997 Form 10-K, SEC App. Tab 2 at 32 (term began July, 1997); March 21, 2000 Enron Proxy Statement, SEC App. Tab 21 at 5 (term ended July, 1999).) This position proved to be an honorarium connected with the PGE acquisition rather than a position of any authority.

[7] Attached for the Court's convenience, as Exhibit 15, is an appendix of Oregon and unpublished authority cited in this brief.

[8] His resignation as Vice Chair in 1999 also coincided with that decision.

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503-221-1440

to which the Complaint attributes much significant knowledge and activity. (Newby Compl. ¶ 86.) Indeed, he never served on **any** committee of Enron's Board. (Newby Compl. ¶ 86.) It is well known that the Enron Board worked substantially by means of its committee system. (*See,* 2000 Proxy Statement, SEC App. Tab 21 at 12.) As one of only two directors who never served on a single committee,[9] Harrison was not among those directors responsible for ensuring that Enron followed safeguards relating to transactions with related parties and SPEs, reviewing compensation received by Enron insiders in connection with those transactions, or reviewing how Enron accounted for those and other transactions that the Complaint singles out as improper. **All of that was done by other directors.** Continuing his separation from Enron as it decided to dispose of PGE, Harrison retired from Enron's Board well before the end of the class period (Newby Compl. ¶ 86).[10] Harrison's experience was in managing a hard-asset based utility and he had no further place in a company that was disposing of hard assets.

3. Harrison as trader.

Plaintiffs correctly allege that Harrison exercised options and traded Enron stock between 1997, when Enron acquired PGE (and Harrison first acquired Enron stock), and 2000, when he retired from PGE. (Newby Compl., Appendix A, pp. 1-7.) The record also shows that he retained nearly half his Enron holdings after his last trade in September 2000 and held those shares as their value fell to nearly zero. (Newby Compl. ¶ 83(l).) Indeed, almost all of Harrison's trades occurred during two windows in and around May and September of 2000 shortly after his departure from PGE, when much of his stock and options vested. All of his trades concluded more than a year before the October 2001 restatement of Enron's earnings that

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[9] Rebecca Mark-Jusbasche was the other.

[10] Plaintiffs' allegation that Harrison left the Board in 2000 is not correct, but they are correct in the proposition that Harrison completed his informal arrangements to leave the Enron Board in 2000, a separation that was formally completed on May 1, 2001.

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prompted this lawsuit. Finally, nearly all of his trades were at a price exceeding three times his option strike price. (*See* SEC Forms 4, attached hereto as Exhibits 3-14.) They were thus perfectly rational for an executive seeking diversification of his investments upon his retirement.

In short, when one sets aside Plaintiffs' conclusory allegations, improper group pleading, and inappropriate hyperbole, the specific allegations in the Complaint and the public record concerning Harrison show that he was a Portland, Oregon utility executive who retired in an orderly and peaceful way, only to get sucked into a Texas-sized tornado of securities litigation swirling around the conduct of others.

B. The Complaint as a whole fails to satisfy Rule 9(b).

Rule 9(b) plainly requires that Plaintiffs state their comprehensive allegations of fraudulent conduct with "particularity."[11] In a securities fraud case, plaintiffs must plead the specific time, place, and contents of false representations, along with the identity of the person making the false representation and what benefit the person received. *Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir 1994); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994). Although a court should take all well-pleaded allegations as true and construe them in the light most favorable to plaintiffs, *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406 (5th Cir. 2001), the court cannot accept as true any of plaintiffs' **conclusory** allegations, *Kaiser Aluminum and Chem. Sales, Inc. v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982). In short, federal courts require that plaintiffs meet the "essentials of the first paragraph of any newspaper story, namely the who, what, when, where, and how." *Melder*, 27 F.3d at 1100 n. 5 (citing with approval the Seventh Circuit's characterization of the pleading standard).

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[11] Rule 9(b) provides that:

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake **shall be stated with particularity**. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Fed. R. Civ. P. 9(b) (emphasis added).

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The Complaint manifestly fails to make such particular allegations against Harrison. Apart from their multiple failures to specifically identify the "what, when, where, and how" of their comprehensive fraud allegations, Plaintiffs never specifically plead facts showing that Harrison was one of those **"who"** participated in **any** of the misconduct they allege. Instead, Plaintiffs rely solely on the strategy of "group" pleading, as demonstrated by paragraphs 89 and 90 of the Complaint. Those paragraphs are not just safety nets designed to protect Plaintiffs' claims if they somehow mistakenly failed to allege everything they knew about Harrison's participation in the comprehensive fraud they allege. Rather, those paragraphs form their core strategy, since Plaintiffs do **nothing at all** to connect Harrison **individually** to their fraud allegations.

Courts in this Circuit have held repeatedly that such "group" pleading cannot meet the requirements of Rule 9(b), particularly after passage of the PSLRA. *In re Sec. Litig. BMC Software, Inc.*, 183 F.Supp. 2d 860, 902, n. 45 (S.D. Tex. 2001); *See also, Schiller v. Physicians Resource Group, Inc.,* No.Civ.A.3:97-CV-3158-L, 2002 WL 318441, * 5 (N.D. Tex. February 26, 2002) ("Although there exists some debate in the district courts whether or not the group pleading doctrine survived the enactment of the PSLRA, this district has come to the resounding conclusion that it does not"); *Branca v. Paymentech,* No.Civ.A.3:97-CV-2507-L, 2000 WL 145083, * 8 (N.D. Tex. February 8, 2000); *Coates v. Heartland Wireless Communications,* 26

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F.Supp 2d 910, 915-16 (N.D. Tex. 1998).[12] Rule 9(b), the PSLRA, and the Fifth Circuit require more than merely pleading guilt by association.[13]

The danger of such group fraud allegations is plainly evident in this case. Many of Plaintiffs' improper group allegations concern events that occurred in Houston while Harrison was CEO of PGE in Portland, Oregon. (*See, e.g.*, Newby Compl. ¶¶ 155(e)-(g); 214(b)-(i), (f)-(g)). Others concern events that occurred after Harrison retired from PGE in 2000 and began separating himself from the Board, a process that was formally complete in Spring 2001. (*See, e.g.*, Newby Compl. ¶¶ 271; 277-78; 324-393).

In sum, because Plaintiffs have sought to allege against Harrison a comprehensive scheme of fraud without making any effort to plead specific facts showing his **individual** participation in that fraud, the Court should dismiss the entire Complaint as to Harrison.

II. The Court Should Dismiss The First Claim Against Harrison.

Plaintiffs' first claim seeks to assert direct liability against Harrison under Section 10(b) and Rule 10b-5, including an allegation of control person liability under Section 20(a) of

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[12] In 1995 Congress refined the Rule 9(b) pleading standard applicable to securities fraud claims by passing the PSLRA, which provides in part that

> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1).

[13] It is worth noting that even where and when it was acceptable, group pleading could only apply to individuals with "direct involvement in the day-to-day affairs of the company." *Coates,* 26 F. Supp.2d at 915. Thus, even if group pleading were still a viable doctrine, it would not save the Complaint because the Plaintiffs fail to make any particular allegations to connect Harrison with the day-to-day affairs of Enron, as opposed to PGE, the Portland, Oregon utility that he ran. Plaintiffs have alleged **no allegations** that remotely touch PGE. As discussed in section II.C.2. below, Plaintiffs' Management Committee allegations are conclusory and violate the PSLRA "information and belief" standard and therefore cannot connect Harrison to the "day to day" affairs of Enron.

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the Exchange Act. The Court should dismiss this claim, because it fails to plead facts sufficient to establish the requisite scienter or the requisite control.

A. Plaintiffs have failed to plead Harrison's scienter.

Besides failing to satisfy Rule 9(b)'s requirement to allege the circumstances of fraud with particularity, Plaintiffs have failed in the first claim to satisfy PSLRA's scienter pleading requirements. Before PSLRA, there was a split in the circuits as to whether a securities plaintiff needed to plead specific facts showing scienter. *Compare Shields v. City Trust Bancorp., Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (requiring on policy grounds, rather than on 9(b)'s particularity component, that securities plaintiffs must "allege facts giving rise to a strong inference of scienter") *with In re Glenfed Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994) (allowing plaintiffs to allege scienter generally without setting out the facts from which scienter could be inferred). The Fifth Circuit joined the courts that required more specific scienter allegations. *Nathenson*, 267 F.3d at 419 ("Under the PSLRA it is clear that conclusory allegations of state of mind do not suffice for this purpose as we have indeed held in cases governed by pre-PSLRA law.")

Congress sought to resolve this circuit split when it imposed the following state of mind pleading requirement under PSLRA:

> [T]he complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (emphasis added). Also important to our analysis here, Congress imposed the additional requirement under PSLRA that for allegations made on information and belief, "the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). If plaintiffs fail to meet any one of PSLRA's pleading requirements, PSLRA requires the Court to dismiss the Complaint. 15 U.S.C. § 78u-4(b)(3)(A).

Plaintiffs have utterly failed to plead any words or deeds of Harrison sufficient to raise **any inference** of scienter, much less the strong inference required by law. As we show

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below, Plaintiffs make no direct allegations of scienter specific to Mr. Harrison. Moreover, their own allegations regarding his trading exonerate rather than implicate him.

1. Plaintiffs make no direct allegations of scienter specific to Harrison.

Plaintiffs bear the heavy burden of alleging facts that create a **strong inference** that Harrison, as an individual, was either a knowing participant in the alleged fraud or acted with severe recklessness. *Nathenson*, 267 F.3d at 408. In this case, the only direct allegations of scienter against Harrison are inadequate because they are (1) group pleading, (2) not specific, and (3) conclusory. Thus, Plaintiffs' allegations create no inference of fraud or recklessness as applied to Harrison.

a. Group pleading did not survive the PSLRA.

In paragraphs 89 and 90 of the Complaint, Plaintiffs assert that group pleading is appropriate as to the Enron Defendants. As we show above, group pleading did not survive the PSLRA. This is no less so for scienter allegations than it is for allegations of fraud. *BMC Software,* 183 F.Supp. 2d at 887.

b. Plaintiffs' "office or position" allegations are insufficient as a matter of law.

Nor are Plaintiffs helped by pleading Harrison's status as a director, for the bare allegation that a person is an officer or director of a company is insufficient to plead scienter as a matter of law. *Nathenson*, 267 F.3d at 424; *Melder*, 27 F.3d at 1103; *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3rd Cir. 1999) ("Generalized imputations of knowledge do not suffice, regardless of the defendants' positions within the company.") Indeed, Plaintiffs' allegations tend to negate any inference of scienter by showing that Harrison was **never** a member of **any** Board committee whatsoever, let alone any committee with audit, finance or compensation responsibilities. (Newby Compl. ¶¶ 86-87.) What Plaintiffs do allege is that Harrison was a member of the "top executive" Management Committee for '97, '98 and '99. They go on to allege, on information and belief, that this committee "was aware of and approved all significant

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503-221-1440

business transactions of Enron, including each of the partnership/SPE deals specified herein." (Newby Compl. ¶ 88.) Because the allegation is asserted solely on information and belief, PSLRA requires Plaintiffs to state with particularity all facts on which that belief is formed. 15 U.S.C. § 78u-4(b)(1). Plaintiffs state **no** facts supporting this belief, which is nothing more than speculation that PSLRA requires the Court to ignore.[14]

This allegation violates PSLRA and Rule 9(b) for another reason. It is the kind of conclusory allegation the Fifth Circuit said, long before PSLRA, that courts should not accept as true. *Kaiser Aluminum*, 677 F.2d at 1050. Plaintiffs would tar all Management Committee members with broad brush responsibility for every transaction challenged in the Complaint. Plaintiffs fail to allege what transactions were discussed at which Management Committee meeting, which committee members were present at any meeting or what information those members had about the transactions. Nor do they allege any facts specific to Harrison (or to any other defendant) connecting this alleged awareness with the approval of **any specific transaction** among the 1030 allegations in the Complaint.

If these reasons are not enough, there is yet another reason this allegation fails, as we address more fully in the next section: Plaintiffs have failed to allege that the Management Committee (or the Board for that matter) had any information that might lead it to believe that any "transaction" or "deal" was improper when "approved."

c. Plaintiffs' fraud by hindsight allegations are not adequate.

To allege scienter, Plaintiffs must plead that the defendant knew the conduct complained of was **wrongful at the time it occurred**. *Tuchman*, 14 F.3d 1061, 1070 (5th Cir.

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[14] It is apparent from the Management Committee allegations that Plaintiffs have no inkling what this group did. They make the unsupported supposition from the committee's name that it must have been involved with all significant deals at Enron. The evidence would actually prove to the contrary, but we deal here only with Plaintiffs' allegations, whose lack of any supporting detail is fatal.

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1994). Plaintiffs fall woefully short, making only a fraud by hindsight or "must have known" allegation that provides no support for any inference of scienter as applied to Harrison.

Numerous decisions hold that plaintiffs may not show scienter based upon conclusory "knew" or "should have known" fraud-by-hindsight allegations. The typical pattern in these fraud-by-hindsight cases is for plaintiffs to attempt to meet their scienter obligations by alleging (1) the company stock tanked, (2) a group of defendants were directors or officers of the company before the stock tanked, and (3) because of their positions, defendants must have possessed some undisclosed information that caused them to know the stock would tank. Plaintiffs here fall prey to the same problem that has caused courts uniformly to reject such pleading attempts. They have failed to allege particular facts showing defendants were aware of negative information **prior to the stock price collapse**. *Advanta Corp.*, 180 F.3d at 539 ("[A]llegations that a securities fraud defendant, because of his position within the company, 'must have known' a statement was false or misleading are 'precisely the types of inferences which [courts], on numerous occasions, have determined to be inadequate to withstand Rule 9(b) scrutiny'") (citing *Maldonado v. Dominguez*, 137 F.3d 1, 10 (1st Cir. 1998)); *Melder*, 27 F.3d at 1103 (Allegations such as, "Because of their board membership and/or executive and managerial positions with [defendant company], defendants * * * knew or had access to [adverse non-public information]" held insufficient to plead scienter); *Calliott v. HFS, Inc.*, No.Civ.A.3:97-CV-09241, 2000 WL 351753, * 8 (N.D.Tex. March 31, 2000); *Branca*, 2000 WL 145083 at *10. This pleading strategy was never valid under Rule 9(b) and certainly did not survive the PSLRA.

d. Plaintiffs' group pleading does not become more probative when mixed with "office or position" and fraud by hindsight allegations.

As to Harrison, Plaintiffs' group pleading allegations are a thin gruel. They seek to supplement this fare with a host of impermissible pleading strategies. For example, Plaintiffs allege that the nature, size and timing of various transactions alleged in the Complaint make it "logical, if not obvious, that all of Enron's officers and directors knew of, or at a minimum acted

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Portland, Oregon 97204
503-221-1440

in reckless disregard of, the falsification of Enron's financial reports * * * " (Newby Compl. ¶ 395.) Plaintiffs start with group pleading, which is not allowed. *BMC Software*, 183 F. Supp.2d at 902, n. 45. They throw in "position of authority" pleading, which is also not allowed. *Nathenson*, 267 F.3d at 424 (the rule in the Fifth Circuit is that "an [insider's] position with a company does not suffice to create an inference of scienter.") They garnish liberally with information and belief pleading without specifying any facts on which the belief is formed, which is not allowed either. 15 U.S.C. § 78u-4(b)(1). They spice it up with a final ingredient: broad legal conclusions of "group-scienter." Together and separately, these allegations fail to implicate Harrison in any way cognizable under the 1934 Act, Rule 9(b) and the PSLRA. These ingredients are each insufficient to show a strong inference of scienter, and their character does not change by being thrown together in the same pot.

Paragraphs 397, 399, and 400 exemplify this effort to create an inference of scienter from a mishmash of legally insufficient group pleading: (1) Enron Defendants **all** had the ability to control **all** Enron public statements (Newby Compl. ¶ 397); (2) Enron Defendants **all** had knowledge of **all** the alleged "adverse non-public information" about Enron (Newby Compl. ¶ 399); and (3) Enron Defendants **all** acted with scienter in that they **all** knew the statements were false when made and **all** participated in a scheme to defraud the investing public due to this universal knowledge (Newby Compl. ¶ 400).

> This Court disapproved of similar allegations in the *BMC Software* case:
>
> Conclusory allegations that they had the requisite scienter based on their executive positions at BMC, their involvement in day-to-day management of its business, their access to internal corporate documents, their conversations with corporate officers and employees, and their attendance at management and Board meetings **are insufficient** * * *.

BMC Software, 183 F. Supp.2d at 887 (emphasis added). Worse yet, some of these group allegations concern Enron Defendants who sat on Board Committees. (*See, e.g.*, Newby Compl. ¶ 398.) Allegations about what Board Committees may have known or done raise no inference

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503-221-1440

of scienter against Harrison. The Complaint admits that Harrison was one of only two Enron Directors **never to sit on a single Board committee**. (Newby Compl. ¶ 86).

The injustice of group pleading, and the reason many of Plaintiffs' allegations do not implicate Harrison, is highlighted further by inconsistencies in the Complaint. The Complaint alleges that Harrison retired from PGE in March of 2000 and that his term on the Board concluded prior to the end of the class period. (Compl. ¶¶ 83(l), 86.) Hence, there are no allegations that adequately connect Harrison with certain news stories in 2001 (Newby Compl. ¶¶ 279, 289, 330, 332, etc.), employee letters to the Board in 2001 (Newby Compl. ¶¶ 340, 358), and Enron internal events in 2001 (Newby Compl. ¶¶ 280, 300(a)-(s), 305, 311, 313-14, 324, 339(a)-(s), etc.). Because Plaintiffs have not adequately alleged a connection between Harrison and these 2001 allegations, the allegations should not be considered by the Court.

2. Plaintiffs' trading allegations fail to create the required strong inference of scienter because Harrison's trading was not unusual or suspicious.

The balance of Plaintiffs' scienter allegations against Harrison and the other Enron directors and officers focuses on their stock trading activity – attempting to create a "strong inference" of scienter from the fact of option exercises and stock sales. (Newby Compl. ¶¶ 401-17.) In this effort, Plaintiffs rely entirely on the Hakala Declaration, appended to the Complaint. However, the Complaint and the Hakala Declaration reveal that: (1) Harrison's supposed "insider" trading coincided with his retirement from PGE; and (2) his trades ceased more than a year before Enron made any restatements of its financials. Under the standards articulated by Plaintiffs' own "expert," Harrison's trades were economically rational and conformed to the behavior of an executive who did **not** have inside knowledge. As is addressed in more detail below, Plaintiffs' attempt to prop up their inadequate scienter allegations via an "expert" declaration is not permissible. More importantly, Plaintiffs' declaration actually exonerates Harrison and shows that Plaintiffs' trading allegations are insufficient to raise any inference of wrongdoing by him.

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Motive and opportunity pleading based solely on supposed insider trading is not sufficient in the Fifth Circuit to create a strong inference of scienter. *Nathenson*, 267 F.3d at 411-12. "[I]nsider trading, without regard to either context or the strength of the inference to be drawn, is not enough." *Id.* at 411 (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999).) There is good reason for this rule. In the absence of any basis to allege what inside information a defendant possessed or how that defendant knew the information, it would only be an **assumption** that the defendant made any trades based on inside information. Yet, Plaintiffs would turn around and use the fact of trading to prove the underlying assumption of inside information. That is a classic bootstrap. Here, Plaintiffs have pleaded nothing more than the fact of Harrison's trades. They affirmatively ignore the context of Harrison's trading because that context strikes a fatal blow to their cause.

Plaintiffs' burden is to show particular facts that create a "strong inference" of scienter. *Nathenson*, 267 F.3d at 412. To use stock trades to accomplish this, they must show that selling by insiders was (1) suspicious in timing and amount and out of line with prior trading practices, *BMC Software*, 183 F. Supp.2d at 901, and (2) unusual in light of the circumstances. *Nathenson*, 267 F.3d at 420-21 ("Insider trading must be 'unusual' to have meaningful probative value") (citing *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2nd Cir. 1995).) Harrison's trading in the present case does not satisfy either of these standards.

a. The Court should disregard Dr. Hakala's declaration.

For Plaintiffs, Dr. Hakala is both oracle and alchemist. He can interpret the illicit meaning behind unremarkable allegations of class period trading by individual defendants. He can also "transform" such allegations into the required strong inference of scienter by waving the magic wand of unexplained, and inexplicable, "statistical" analysis. Dr. Hakala's analysis is like the Complaint redux: sweeping in its conclusions with nearly no specific factual content. He purports to do a statistical analysis, but his declaration is merely a dressed-up legal conclusion:

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selling by insiders was illegal because it was done while the defendants were "aware" of unspecified material, nonpublic information. *See, e.g.*, 17 C.F.R. § 240.10b5-1(b).

As ably stated by a California district court faced with a similar ploy, "[c]onclusory allegations and speculation carry no additional weight merely because a plaintiff placed them within the affidavit of a retained expert." *Demarco v. Depotech Corp.*, 149 F. Supp.2d 1212, 1222 (S.D. Ca. 2001). The *Demarco* court refused to consider an expert affidavit filed with the complaint because it raised complex evidentiary issues at an inappropriate time. *Id.* at 1221. Further, an expert declaration cannot relieve plaintiffs of their pleading burdens under Rule 9(b) and the PSLRA, both of which require factual specificity. *Id.* at 1221-22. Other courts have confirmed that an expert declaration cannot revive an inadequate pleading. *See, e.g., Mortensen v. Americredit Corp.*, 123 F. Supp.2d 1018, 1026-27 (N.D.Tex. April 21, 2000), *aff'd,* 240 F.3d 1073 (5th Cir. 2000) (expert declaration will not create an inference of scienter where it is in conflict with other materials referenced in the complaint and the underlying allegations are inadequate).

For these reasons, Harrison respectfully requests that Dr. Hakala's declaration be stricken from the Complaint and not considered by the Court.

b. Harrison's trading was not unusual or suspicious in timing or amount.

Plaintiffs allege that Harrison (1) sold a comparatively small number of shares of Enron stock between July 1997, when he joined Enron as a result of Enron's acquisition of PGE, and April 2000; (2) sold a large number of shares between May and September 2000; (3) sold no shares after September 2000; and (4) continues to hold 938,262 vested Enron options and shares of Enron stock. Based solely on these allegations, Plaintiffs and their expert conclude that Harrison must have engaged in illegal insider trading.

To the degree the Court considers Dr. Hakala's declaration, it says only two things about Harrison: (1) it expressly exonerates Harrison in the "premature option exercise" analysis

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(Hakala Decl. ¶ 9(e)), but (2) it nevertheless strains to find significance in the fact that Harrison traded during the class period because he "avoided loss" by doing so (Hakala Decl. ¶ 9(f)).[15] Based on these circumstances, Dr. Hakala concludes that Harrison's behavior "was consistent with foreknowledge that the share price of Enron was inflated." (Hakala Decl. ¶ 9(f).) But the Complaint pleads otherwise. The Complaint admits that scientific standards require that a statistical analysis reach a level of certainty of at least 95% to support a conclusion that a seller has traded on inside information. (Newby Compl. ¶ 415.) The Complaint further admits that Dr. Hakala has a **less** than 95% certainty level that **Harrison** traded on inside information. *Id.* **Thus the Complaint itself unequivocally establishes that Dr. Hakala's study fails to show that Harrison traded on inside information.**

Just as problematic for Plaintiffs, Dr. Hakala's would-be conclusion that Harrison traded on inside information willfully ignores numerous explanatory facts available to him in materials he represents to the Court that he has reviewed. For example, Dr. Hakala ignores the fact, easily ascertainable from the public documents he claims to have reviewed, that, prior to July 1, 1997, Harrison had no association with Enron. He was the chairman and CEO of PGE, in Portland, Oregon. Enron bought PGE on July 1, 1997. That is when Harrison's shares in PGE were converted to Enron shares and when he became an officer and director of Enron, slightly more than one year prior to the beginning of the class period. In other words, Harrison had no trading history prior to the class period. Class period trades are not indicative of scienter when a

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[15] What Dr. Hakala means in applying his "avoided loss" analysis to Harrison is difficult to discern, in part because he provides no definition for what he means by the term. Perhaps he means that, if the seller had waited to sell the stock at a later time, he would have sold at a price below what he paid for it. By selling earlier, presumably with inside information, the seller was able to avoid that loss. However, "loss" in that sense is not an issue when an officer or director exercises options and simultaneously sells the stock, a fact scenario that describes nearly all of Harrison's trades. (See Forms 3 and 4, attached hereto as Exhibits 3-14.) The only non-option trades Harrison made were to sell stock he received as grants, which likewise presents no opportunity for loss. (See Forms 3 and 4, attached hereto as Exhibits 3-14.) Thus, loss avoidance does not apply to Harrison.

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defendant recently joined a company and has no trading history. *BMC Software*, 183 F. Supp.2d at 901-02; *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 987-88 (9th Cir. 1999).

Dr. Hakala also ignores the vesting schedule of Harrison's options. No one, Harrison included, can sell shares before the options underlying the shares have vested. This information is easily obtainable from the SEC filings (Forms 3 and 4) that Dr. Hakala claims to have reviewed. As shown by the Shares Vested vs. Shares Sold Ken L. Harrison Graph ("Vesting Graph"), attached as Exhibit 1, and the Shares Vested vs. Shares Sold Ken L. Harrison Matrix ("Vesting Matrix"), attached as Exhibit 2, the number of vested options and shares of Enron stock that Harrison owned increased dramatically in the second quarter of 2000. It was in this quarter and the following quarter that Harrison made the majority of his Enron stock trades. (Vesting Graph, Ex. 1.) The explanation is simple. As noted in the Complaint, Harrison retired from his position as CEO and Chairman of PGE on March 31, 2000. The next day, April 1, 2000, more than 1.1 million of Harrison's unvested options immediately vested. (See, SEC Forms 4 May 2000, August 2000 and September 2000, attached hereto as Exhibits 10-14.) As a result, Harrison – who had never previously owned even 700,000 vested options – suddenly owned almost two million vested options and shares of Enron stock. As noted in *Silicon Graphics*, 183 F.3d at 987-988, the trading of shares that first become available for trade during the class period is not indicative of insider trading.

Harrison's retirement trading was completed by September of 2000, more than a year prior to the negative announcements that Dr. Hakala concludes caused Enron's stock to collapse. (Hakala Decl. ¶ 26.) These trades were so far in advance of the negative reports in late 2001 that **no inference** of suspicious timing can arise. *See, e.g., BMC Software*, 183 F. Supp.2d at 903 (insider trading not probative because "[t]o the extent any individual Defendant sold some of his BMC holdings, he generally did so well before or well after any of the earnings announcements targeted by Plaintiffs in their amended complaint. Nor is there any pattern of large trades before negative earnings announcements or similar disclosures.") As in *BMC*,

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Harrison's trading was not suspiciously associated with times just prior to negative disclosures. Therefore, no inference arises.

Immediately following his retirement from PGE, in May, August, and September 2000, Harrison exercised about half of his vested options. After September 18, 2000, Harrison did not exercise another option or sell another share of Enron stock (Compl. App. C.). As is noted above, Harrison's trading in connection with his retirement cannot raise any inference of insider knowledge. Indeed, a summary of Dr. Hakala's analysis makes it clear that the only permissible inference from Harrison's trading is that he sought liquidity and wealth diversification upon retirement:

DR. HAKALA DESCRIBES AN ILLEGAL INSIDER TRADER	HARRISON'S TRADING FACTS FROM PUBLIC DOCUMENTS AND THE COMPLAINT
"Insider traders" increase their sales in the year before a negative earnings event. (Hakala Decl., ¶ 11.)	Harrison **sold no Enron stock** in the year before Enron made any negative earnings announcement. (Newby Compl., App C.)
"Insider traders" exercise options prematurely when the exercise price is greater than 50% of the current Enron stock price, because they know bad news is coming. (Hakala Decl., ¶ 11.)	Harrison **exercised no options** when the exercise price was greater than 50% of the current Enron stock price. (Hakala Decl., ¶ 25.)
Enron Defendants that traded from June 1996 until October 2001 traded when Enron stock was inflated. (Hakala Decl., ¶ 45.)	Harrison did indeed trade during this period....because **his entire career** at Enron occurred during this period. (*See* 1999 Enron Proxy Statement, SEC App. Tab 20 at 5; Newby Compl. ¶ 83(l).)

Dr. Hakala's description of non-culpable insider behavior gibes perfectly with Harrison's behavior:

DR. HAKALA DESCRIBES AN EXECUTIVE WITHOUT KNOWLEDGE	HARRISON'S TRADING FACTS FROM PUBLIC DOCUMENTS AND THE COMPLAINT
Ordinarily, risk-averse executives will exercise options early "when the stock price [is] at least three to four times greater than the exercise price." (Hakala Decl., ¶ 13, n. 21.)	**97% of Enron Options** exercised by Harrison were exercised when the price of Enron stock was "at least three to four times greater than the exercise price," and all exercises were at times when the market

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DR. HAKALA DESCRIBES AN EXECUTIVE WITHOUT KNOWLEDGE	HARRISON'S TRADING FACTS FROM PUBLIC DOCUMENTS AND THE COMPLAINT
	price more than doubled the exercise price. (*See* Forms 3 and 4, attached as Exhibits 3-14.)
Insiders will "naturally tend to sell their company's shares over time for wealth diversification and liquidity purposes." (Hakala Decl., ¶¶ 11, 13.)	Harrison sold roughly 50% of his Enron holdings upon his retirement for liquidity and diversification. He stopped selling Enron stock in September of 2000, even though he still held (and holds today) 938,262 vested options and shares. (Newby Compl. ¶ 402.)
"Directors and top executives often limit their sales of shares for appearance and other economic and non-economic reasons." (Hakala Decl.¶ 14.)	Harrison's pre-retirement trading was limited to only 13.5% of his total final holdings of Enron options and shares. There is no negative "appearance" associated with selling shares upon retirement. (Forms 3 and 4, Complaint App. C.)

Finally, an examination of Dr. Hakala's analysis of former Enron CEO Kenneth Lay's trading is instructive. Dr. Hakala notes that Lay sold shares in 1999 and 2000, just like Harrison. (Hakala Decl. ¶ 31.) Dr. Hakala notes that, because Lay sold shares prior to 2001, the wealth diversification motive to sell **should have been reduced**. (Hakala Decl. ¶ 31.) Dr. Hakala then notes that Lay's selling accelerated rapidly in mid-2001 with total volume reaching "extraordinary" levels in 2001. (Hakala Decl. ¶ 32.) Many of these 2001 trades qualified as premature option exercises. (Hakala Decl. ¶ 34.) Dr. Hakala concludes that the accelerated selling in 2001 supports (to a 99.9% "degree of confidence") that Lay had foreknowledge about future stock declines. (Hakala Decl. ¶ 36.)[16]

[16] We offer no opinion on the validity of Dr. Hakala's analysis as to Lay. We merely contrast the 99.9% conclusions Dr. Hakala is willing to draw as to Lay with the converse behavior of Harrison.

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Contrast Harrison. Harrison sold shares in 2000 in connection with his retirement, and **then stopped**. In other words, when his wealth diversification motive apparently **was reduced**, he stopped selling. Unlike his conclusions about Lay, Dr. Hakala does not assert **any premature option exercises** by **Harrison**. (Hakala Decl. ¶ 25.) Further, to the degree Lay's accelerated selling in 2001 supports any inference of insider knowledge as to either those trades or any earlier trades, it must also be true that Harrison's failure to sell any of his nearly one million shares/vested options in 2001—despite the fact that he could not have had any less "insider" knowledge in 2001 than he supposedly had in 2000—supports an inference that Harrison did not trade on inside information in 2000 or at any other time. Again, Dr. Hakala paints a picture that wholly exonerates Harrison.

In sum, Harrison behaved exactly as Dr. Hakala suggests a rational, risk-averse executive should behave if that executive **does not have** "insider knowledge." He exercised those options that were "deep in the money," at the time when he left PGE's employment, and held those options that were not. Far from creating a strong inference of scienter on the part of Harrison, Dr. Hakala's declaration presents compelling evidence that Harrison lacked scienter.[17]

B. Plaintiffs have failed to plead that Harrison was a controlling person.

As an alternative basis for liability, Plaintiffs assert liability in the first claim against all defendants under Section 20(a) of the Exchange Act. Section 20(a) imposes joint and several liability on every person who, "directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder * * * unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the

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[17] Dr. Hakala assumes that class period trading must be explicable either by "chance" or insider knowledge. (Hakala Decl. ¶ 4 ("My analysis showed only a remote chance * * * that the benefits captured by the Insider Sales occurred by chance alone, independent of the [guilty knowledge].") This assumption renders his study wholly disingenuous. The materials that he claims to have reviewed, the Complaint and Forms 3 and 4 for Harrison, clearly show all facts referenced here: the vesting schedules and Harrison's retirement from PGE. Dr. Hakala's straw-man choice of "chance" or illegal information is not science, it is advocacy.

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violation or cause of action" 15 U.S.C. § 78t(a). In this case, Plaintiffs implicitly assert that Harrison had "control" over a person who violated Section 10(b) by committing securities fraud.

This claim must be dismissed for several pleading deficiencies. In particular, Plaintiffs have (1) failed to assert that Harrison was a culpable participant in the alleged violations of Section 10(b) as required by Fifth Circuit law; (2) failed to make specific allegations against Harrison as required by the PSLRA;[18] (3) failed to plead with sufficient particularity under Rule 9(b) a claim that is necessarily predicated on securities fraud and culpable participation; and (4) failed to identify who committed the alleged primary violation and how Harrison "controlled" such person or persons. In light of these substantial pleading deficiencies, Plaintiffs' Section 20(a) claim against Harrison should be dismissed.

1. The failure to allege culpable participation dooms this claim.

Plaintiffs fail to allege that Harrison was a "culpable participant" in the alleged fraud. While courts in the Fifth Circuit have not been entirely consistent in their interpretation of "controlling person" liability, several recent cases have recognized a requirement that the plaintiff show the defendant was a "culpable participant" in the asserted fraud in order to impose Section 20(a) liability. The Fifth Circuit itself recognized this requirement in 1990 in *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990),[19] and obliged the plaintiff to allege specific facts as to each individual defendant showing culpable participation in the primary violation.

Subsequent district court decisions have followed the lead of *Dennis*. *See, e.g., BMC Software, Inc.*, 183 F. Supp.2d at 868, n. 17 ("Controlling person liability is an alternative

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[18] As is noted at n. 12, *supra,* Plaintiffs have failed to allege facts sufficient to allow group pleading against Harrison even prior to enactment of the PSLRA. They fail to adequately allege **Harrison's** "day to day" involvement with Enron affairs.

[19] *Abbott v. Equity Group,* 2 F.3d 613, 620, n. 18 (5th Cir. 1993), noted that *Dennis* was a departure from previous Fifth Circuit cases regarding "culpable participation." Because the culpable participation issue was not necessary to the *Abbott* court's decision, *Dennis* stands.

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ground for liability from that of a primary violation. Thus a plaintiff may allege a primary Section 10(b) violation by a person controlled by the defendant and culpable participation by the same defendant in the perpetration of the fraud."); *see also RGB Eye Assocs. v. Physician Resource Group, Inc.*, No.3:98-CV-1715-D, 1999 US Dist LEXIS 21940 *39-40 (N.D. Tex. May 13, 1999) (stating that, in order to plead a Section 20(a) claim, plaintiff must allege "particularized facts as to each controlling person's culpable participation in the fraud perpetrated by the controlled person"). Plaintiffs have not asserted with sufficient particularity that Harrison was a culpable participant in the alleged fraud. The Court should therefore dismiss this claim.

2. The failure to allege this claim with specificity dooms it as well.

Where fraudulent activity is the basis for a claim—any claim—the plaintiffs must satisfy the particularity requirements of Rule 9(b). *See Lone Star Ladies Investment Club*, 238 F.3d 363, 368 (5th Cir. 2001). The Court must ignore any allegation based on fraud that does not comply with this requirement. *See id.* Plaintiffs' Section 20(a) claim against Harrison is necessarily predicated on an alleged primary violation of Section 10(b), *i.e.,* fraud. Further, as noted, Plaintiffs must allege culpable participation in the specific fraudulent conduct that is the primary violation. Thus, the particularity requirement of Rule 9(b) applies to Plaintiffs' Section 20(a) allegations. Because Plaintiffs have not stated any Section 20(a) claim as to Harrison with sufficient particularity to satisfy Rule 9(b), the claim should be dismissed.

3. Group pleading does not supply the missing particularity.

In jurisdictions that recognize the culpable participation standard, courts have applied the PSLRA to Section 20(a) claims. *See, e.g., Mishkin v. Ageloff*, No.97 Civ.2690 LAP, 1998 WL 651065, **23-25 (S.D.N.Y. September 23, 1998); *In re CDNOW, Inc. Sec. Litig.*, 138 F. Supp.2d 624, 644 (E.D. Penn. 2001) ("The heightened pleading standards of the PSLRA apply in so far as 'a plaintiff must plead the particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud'") (internal citations omitted). In direct contravention of PSLRA's requirements, Plaintiffs fail to make any individualized allegations

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against Harrison whatsoever. Instead, Plaintiffs rely on "group pleading," and essentially assert in the first claim that **all** the Enron Defendants violated both Section 10(b) and Section 20(a) by their conduct. These allegations are egregious examples of group pleading and lack the factual particularity expressly required by the PSLRA.

Plaintiffs do not identify any particularized facts to support their claim that **Harrison**, and specifically Harrison, "controlled," induced, or participated with the person or persons who committed the alleged fraud. Indeed, Plaintiffs generally do not distinguish among the individual Enron Defendants (Newby Compl. ¶¶ 84, 90, 400), or at most only distinguish smaller "groups," such as the Enron Management Committee (Newby Compl. ¶¶ 88, 397). As we have shown, such group pleading did not survive the PSLRA. Plaintiffs also ignore the PSLRA's command that, "if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). None of Plaintiffs' control person allegations sets forth specific facts that could have caused Plaintiffs to believe that Harrison or any other alleged control person was connected to any alleged statements or omissions. Therefore, these control person allegations should be ignored.

4. Plaintiffs' failure to allege any facts demonstrating control is also fatal.

To state a claim under Section 20(a), a plaintiff in the Fifth Circuit is required at a minimum to allege facts showing that the defendant possessed actual control over the person who committed the securities violation. *See Abbott*, 2 F.3d at 620. In this case, Plaintiffs have pleaded their claims with such generality that they do not even distinguish between those who allegedly committed the primary violations of the Exchange Act and those who are allegedly liable as a "controlling person."[20] Moreover, as previously stated, Plaintiffs have failed to make

[20] It is difficult to identify which, if any, paragraphs of the Complaint are directed to the controlling person liability claim. Plaintiffs appear to be fishing for as many defendants as possible under a Section 10(b) theory. If any defendants escape this net, Plaintiffs "dynamite the

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any specific allegations regarding Harrison's "control." Reading the Complaint generously, Plaintiffs assert at most that Harrison was a director and/or officer of Enron at certain points during the class period. But mere status as a director or officer is insufficient to establish controlling person liability. *See Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 195 (5th Cir. 1980) ("As a director without effective day-to-day control and without knowledge he was not liable as a controlling person."); *Zishka v. American Pad and Paper Co.*, 2001 WL 1748741, *1 (N.D. Tex.) ("Status alone as to persons not involved in day to day management is legally insufficient to support a Section 20(a) claim.").

Moreover, Plaintiffs' specific allegations about Harrison negate any general allegation of control. For example, Plaintiffs allege: (1) Harrison had ceased to be an officer or director prior to the end of the class period; (2) Harrison was the CEO of a subsidiary located in Portland, Oregon, regarding which Plaintiffs make no allegations of wrongdoing (Newby Compl. ¶ 83(l)); and (3) Harrison was not a member at **any** time of **any** Board Committee, much less those that had information, access, or control over finance or audit-related decisions (Newby Compl. ¶ 86.) Each of these specific allegations severely undercuts the Plaintiffs' more general allegations that Harrison, as a member of a group Plaintiffs designate as "the Enron Defendants," had actual control over the wrongdoers and primary violations.

For all the foregoing reasons, Plaintiffs' Section 20(a) claim against Harrison should be dismissed for failure to state a claim under the applicable pleading standards.

III. The Court Should Dismiss The Second Claim Against Harrison.

Liability under Section 20A for contemporaneous trading of stock while in the possession of material nonpublic information requires a predicate offense under the Exchange Act: "Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic

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pool" with a Section 20(a) theory, employing broad and conclusory control person allegations to groups of defendants.

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information shall be liable in an action in any court of competent jurisdiction to [certain counter parties]." 15 U.S.C. § 78t-1. For all the reasons Plaintiffs have failed to state claims under Section 10(b) or Rule 10b-5 against Harrison, they have failed to state claims for contemporaneous insider trading.

IV. The Court Should Dismiss The Fourth Claim Against Harrison.

Plaintiffs' fourth claim (Newby Compl. ¶¶ 1017-1030) alleges violations of the TSA relating to two offerings of debt securities: $250 million of 6.40% Notes and $250 million of 6.95% Notes. The particularity burden of Rule 9(b) applies to these claims. *Williams v. WMX Technologies, Inc.* 112 F.3d 175, 177 (5th Cir. 1997) (applying Rule 9(b) to state law claims of fraud and misrepresentation where state law claims "rely upon the same misrepresentations as the federal claims"). For the reasons stated in section I.B., above, Plaintiffs have failed to adequately plead the time, place, and contents of false representations, the identity of the speaker, and what the person obtained thereby (the "who, what, when, and where") required to state a TSA claim against Harrison.[21] *Williams,* 112 F.3d at 178. Plaintiffs have even failed to specify the specific statutory provision that might give rise to liability for Harrison. This claim should therefore be dismissed.

The second problem with this claim is that the TSA simply does not apply to these specific transactions. Plaintiffs allege that "JP Morgan and Lehman Brothers together offered for sale and sold the 6.40% Notes and 6.95% Notes purchased by the Washington Board and the members of the Note subclass." (Newby Compl. ¶ 1023.) Enron, an Oregon corporation headquartered in Texas, sold bonds to New York investment banks. The New York bankers sold bonds to non-Texas plaintiffs. Texas law provides that a "person who offers or sells a

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[21] Plaintiff Washington Board purchased these notes on or about July 7, 1998, prior to the class period. (*See* Washington Board Certification Pursuant to Federal Securities Laws, executed December 20th, 2001.) Rule 9(b) requires dismissal of class period allegations and it applies with even more force to this claim that arises during a time period when most of the events alleged in the Complaint had not occurred.

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security * * * by means of an untrue statement of material fact * * * is liable **to the person buying the security from him** * * *." TSA Art. 581-33(A)(2) (emphasis added). No Plaintiff is alleged to have purchased any of these securities from Enron.

In *Lone Star Ladies Investment Club v. Schlotzky's*, the Fifth Circuit applied nearly identical language from Section 12 of the Securities Act to find the issuers not liable "because the public does not purchase from the issuers." 238 F.3d 363, 370 (2001).[22] In the present case, under the plain language of the statute, Plaintiffs may not recover from the sellers' seller either. *See, e.g., Pinter v. Dahl*, 486 U.S. 622, 643-44, n. 21, 108 S.Ct. 2063, 2077 (1988) ("[Under Section 12 of the 1933 Act] a buyer cannot recover against his seller's seller* * *"); *Hendricks v. Thornton*, 973 S.W.2d 348, 369 (Tex. App. Beaumont 1998) (noting similarity between language of TSA Art. 581-33(A) and Section 12 of the 1933 Act and holding that accountants were not "sellers" within meaning of either statute).

Plaintiffs may not rely on TSA Art. 581-33(C), which imposes liability on non-selling issuers, because Harrison is not an issuer. Plaintiffs offer no other basis to hold Harrison liable under the TSA. Thus, the fourth claim should be dismissed.

CONCLUSION

One of the central reasons for Rule 9(b) and subsequent securities reforms is to protect defendants from harm to their reputation arising from baseless fraud allegations. *Melder*, 27 F.3d at 1100. It is clear from Plaintiffs' Complaint that they believe they have been victimized in a *bona fide* financial scandal.

But even if the Court finds that Plaintiffs' claims against **some defendants** are adequate to subject those defendants to the expense, harassment and reputational damage of securities litigation, it does not follow that Plaintiffs' claims against **all defendants** can go forward. The PSLRA and Rule 9(b) raise legal hurdles Plaintiffs must clear to seek recovery.

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[22] Section 12 provides that a seller could only be liable "to the person purchasing such a security from him." *Id.*

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For the reasons set forth in this Motion, Plaintiffs have failed to meet these standards against Ken L. Harrison, a Portland, Oregon utility executive who only became involved with Enron when it acquired his company.

For the reasons set forth above, Harrison respectfully requests that this Court dismiss each and every claim of the *Newby* Complaint and that the Court do so with prejudice.

DATED this 8th day of May, 2002.

Respectfully submitted,

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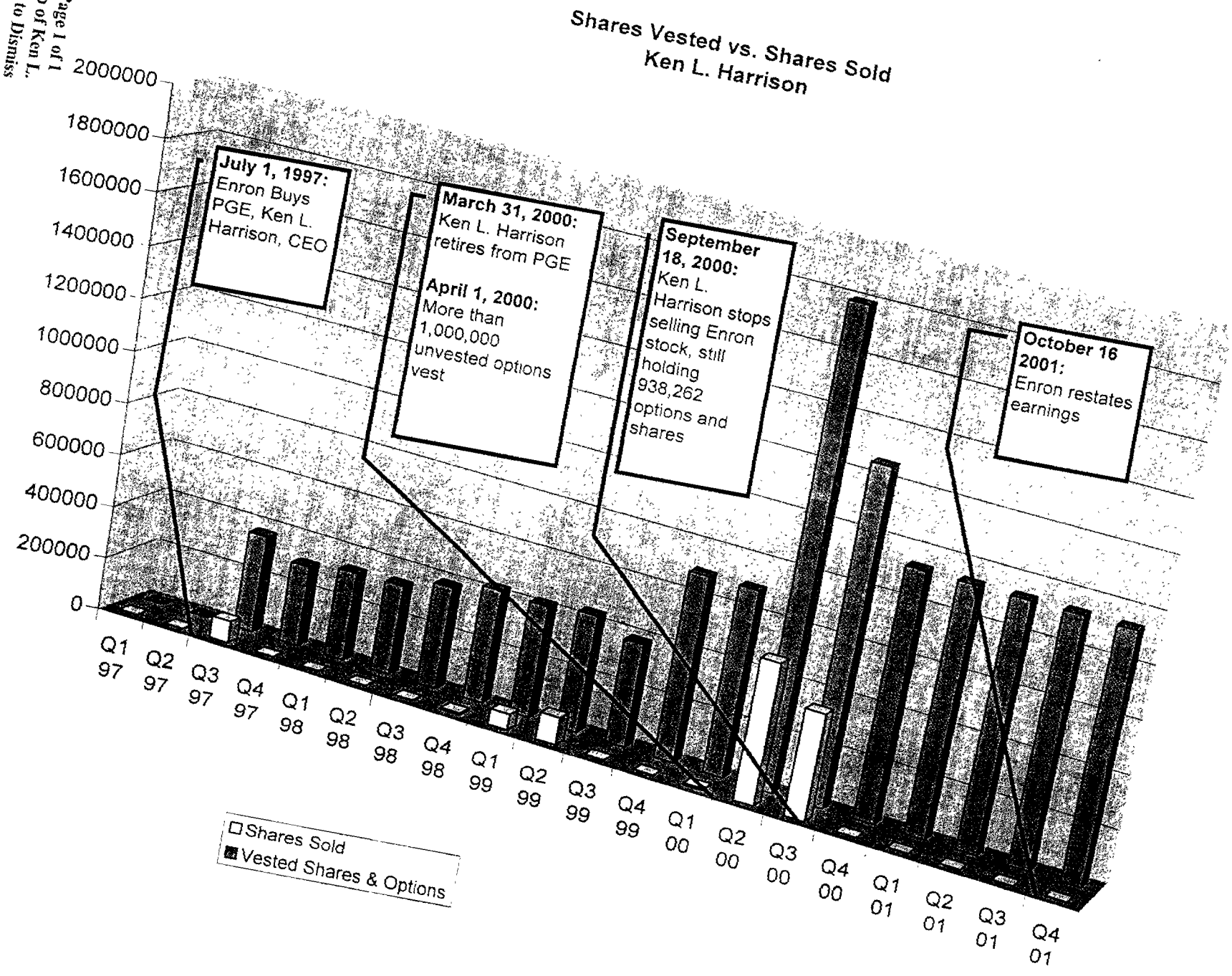
Shares Vested vs. Shares Sold
Ken L. Harrison
2000000
1800000
1600000
1400000
1200000
1000000
800000
600000
400000
200000
0
July 1, 1997: Enron Buys PGE, Ken L. Harrison, CEO
March 31, 2000: Ken L. Harrison retires from PGE
April 1, 2000: More than 1,000,000 unvested options vest
September 18, 2000: Ken L. Harrison stops selling Enron stock, still holding 938,262 options and shares
October 16 2001: Enron restates earnings
Q1 97
Q2 97
Q3 97
Q4 97
Q1 98
Q2 98
Q3 98
Q4 98
Q1 99
Q2 99
Q3 99
Q4 99
Q1 00
Q2 00
Q3 00
Q4 00
Q1 01
Q2 01
Q3 01
Q4 01
Shares Sold
Vested Shares & Options

Shares Vested vs. Shares Sold
Ken. L. Harrison

1997	Q1 97	Q2 97	Q3 97	Q4 97
Shares Sold	0.00	0.00	79,912.00	0.00
Shares Vested	0.00	0.00	373,917.20	307,339.20
1998	**Q1 98**	**Q2 98**	**Q3 98**	**Q4 98**
Shares Sold	0.00	0.00	0.00	7,266.00
Shares Vested	335,979.20	340,931.90	388,931.90	430,608.40
1999	**Q1 99**	**Q2 99**	**Q3 99**	**Q4 99**
Shares Sold	57,260.00	100,000.00	0.00	0.00
Shares Vested	423,342.40	441,178.20	389,178.20	699,948.90
2000	**Q1 00**	**Q2 00**	**Q3 00**	**Q4 00**
Shares Sold	7,281.00	529,527.00	400,000.00	0.00
Shares Vested	699,948.90	1,791,347.50	1,261,820.50	938,262.00
2001	**Q1 01**	**Q2 01**	**Q3 01**	**Q4 01**
Shares Sold	0.00	0.00	0.00	0.00
Shares Vested	938,262.00	938,262.00	938,262.00	938,262.00

Shares Sold are taken from App. C to the Newby Complaint, with additional sales from Mr. Harrison's Forms 4. Shares Vested are taken from Mr. Harrison's Forms 3 and 4 and Enron's 2001 Proxy Statement.

Shares Sold during a quarter are deducted from the Shares Vested column for the following quarter.

Shares Vested vs. Shares Sold
Ken L. Harrison
Exhibit 2 to Ken L. Harrison's Motion to Dismiss – Page 2

Explanatory Notes:

The matrix at page one of this Exhibit is a summary of Harrison's shares sold and shares vested from which the graph in Exhibit One was derived. The vesting information is derived from the footnoted vesting schedules that appear on page two of the SEC Forms 3 and 4 that follow. The original vesting schedules are self-explanatory. (See, e.g., November 1998 Form 4, pg. 2, attached as Exhibit 6 to the Motion to Dismiss (showing vesting in October 1998-2001 and October 2003)). The large "bump" in vested shares that occurs between Q1 and Q2 2000 also is derived from Forms 4. On the second pages of the Forms 4 filed in May, August and September 2000, under heading 6, the "Date Exercisable" - or vesting date - of the various options is listed as 4/01/00, notwithstanding the fact those options originally had diverse vesting schedules, as shown in earlier Forms 4. Ken L. Harrison retired from PGE effective March 31, 2000. Newby Comp. ¶ 83(l). As noted, his options vested in an accelerated manner on the next day. A permissible inference, and indeed the correct inference, is that all Harrison's options vested immediately as a result of his retirement.

The only option for which this accelerated vesting schedule is not explicit from the attached Forms 4 is the grant of 892,310 options at $38.50 per share (post-split) that is recorded on Harrison's January 2000 Form 4, attached as Exhibit 9 to the Motion to Dismiss. As shown on that Form 4, the option originally was scheduled to vest in increments, with full vesting on December 31, 2001. But Enron's 2001 Proxy Statement, (SEC App. Tab 22 at 9-10), shows that the 858,900 options remaining from that grant (892,310 less 33,410 shares sold 9/18/2000, see September 2000 Form 4, attached as Exhibit 14 to the Motion to Dismiss) fully vested sometime before February 15, 2001, much earlier than they were scheduled to vest originally. A permissible inference, and indeed the correct inference, is that the entire 892,310 shares vested pursuant to the same accelerated vesting event (Harrison's retirement) in April of 2000 that is demonstrated on the other Forms 4.

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FORM 3

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0104
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

INITIAL STATEMENT OF BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person*

HARRISON KEN L.
(Last) (First) (Middle)

121 S.W. SALMON STREET
(Street)

RTLAND OR 97204
(City) (State) (Zip)

2. Date of Event Requiring Statement (Month/Day/Year)
07/01/97

3. IRS or Social Security Number of Reporting Person (Voluntary)

4. Issuer Name and Ticker or Trading Symbol
ENRON CORP. (ENE)

5. Relationship of Reporting Person(s) to Issuer (Check all applicable)
X Director ___ 10% Owner
X Officer (give title below) ___ Other (specify below)
VICE CHAIRMAN

6. If Amendment, Date of Original (Month/Day/Year)

7. Individual or Joint/Group Filing
X One Reporting Person
___ More than One Reporting Person

Table I – Non-Derivative Securities Beneficially Owned

1. Title of Security (Instr. 4)	2. Amount of Securities Beneficially Owned (Instr. 4)	3. Ownership Form: Direct (D) or Indirect (I) (Instr. 5)	4. Nature of Indirect Beneficial Ownership (Instr. 5)
Common Stock	45,058.635	D	
Common Stock	7,596.233	I	by 401(k) Plan
Common Stock	393.000	I	by Spouse

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.
* If the form filed by more than one reporting person, see Instruction 5(b)(v).

(Over)
SEC 1473 (7-96)

FORM ... (continued) Table II -- Derivative Securities Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 4)	2. Date Exercisable and Expiration Date (Month/Day/Year)		3. Title and Amount of Securities Underlying Derivative Security (Instr. 4)		4. Conversion or Exercise Price of Derivative Security	5. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 5)	6. Nature of Indirect Beneficial Ownership (Instr. 5)
	Date Exercisable	Expiration Date	Title	Amount or Number of Shares			
Employee Non-Qualified Stock Option (right to buy)	10/02/95	10/02/00	Common Stock	117,900.000	$16.0305	D	
Employee Non-Qualified Stock Option (right to buy)	(1)	07/01/07	Common Stock	120,000.000	$41.4375	D	

Explanation of Responses:
(1) The option becomes exercisable in 20 percent increments on grant date and on each of the next four anniversary dates.

Ken L Harrison
**Signature of Reporting Person

7/2/97
Date

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

Exhibit 4 - Page 1 of 2
Memo in Supp of Ken L. Harrison's Mo to Dismiss

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	X Director ___ 10% Owner
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary)	X Officer (give title below) ___ Other (specify below)
PORTLAND OR 97204 (City) (State) (Zip)	4. Statement for Month/Year: August 1997	VICE CHAIRMAN
	5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	08/29/97	S		19,956.000	D	$38.5000		D	
Common Stock	08/29/97	M		20,000.000	A	$16.0305		D	
Common Stock	08/29/97	S		20,000.000	D	$38.5000	25,102.635	D	
Common Stock							7,837.176	I	by 401(k) Plan
Common Stock							393.000	I	by Spouse

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

(Over)
SEC 1474 (7-96)

FORM 4 (continued)

Table II -- Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$16.0305	08/29/97	M			20,000.000	10/02/95	10/02/00	Common Stock	20,000.000		97,900.000	D	

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

Ken L Harrison
**Signature of Reporting Person

7/6/97
Date

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

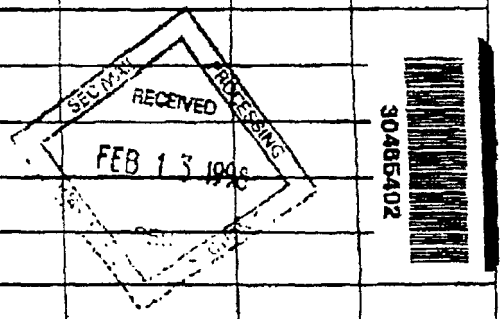
Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	X Director ___ 10% Owner X Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary) 548-56-2105	4. Statement for Month/Year January 1998
PORTLAND OR 97204 (City) (State) (Zip)	5. If Amendment, Date of Original (Month/Year)	VICE CHAIRMAN 7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I — Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			



Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

(Over)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$41.5625	12/31/97	A	V	33,335.000		(1)	12/31/04	Common Stock	33,335.000		33,335.000	D	
Employee Non-Qualified Stock Option (right to buy)	$41.5625	12/31/97	A	V	7,430.000		(2)	12/31/07	Common Stock	7,430.000		7,430.000	D	
Employee Non-Qualified Stock Option (right to buy)	$60.1250	01/19/98	A	V	14,320.000		01/19/98	01/19/05	Common Stock	14,320.000		14,320.000	D	

Explanation of Responses:
(1) The option becomes exercisable in 20 percent increments on grant date and on each of the next four anniversary dates.
(2) The option becomes exercisable in 33.33 percent increments on June 30, 1998, 1999, and 2000, respectively.

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations.
See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number

Ken L. Harrison
**Signature of Reporting Person

2/9/98
Date

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	X Director ___ 10% Owner
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary)	X Officer (give title below) ___ Other (specify below)
PORTLAND OR 97204 (City) (State) (Zip)	4. Statement for Month/Year: November 1998	VICE CHAIRMAN
	5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	10/12/98	A	V	37,800.000	A	$0.0000		D	
Common Stock	11/04/98	S		987.000	D	$56.3125		D	
Common Stock	11/04/98	S		2,253.000	D	$56.5000		D	
Common Stock	11/04/98	S		0.876	D	$55.0630	59,690.000	D	
Common Stock							8,014.387	I	by 401(k) Plan
Common Stock	11/04/98	S		393.000	D	$56.3125	0.000	I	by Spouse

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

(Over)

* If the form filed by more than one reporting person, see Instr. 4(b)(v).

SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$50.9375	10/12/98	A	V	117,925.000		10/12/03	10/12/08	Common Stock	117,925.000			D	
Employee Non-Qualified Stock Option (right to buy)	$50.9375	10/12/98	A	V	140,285.000		(1)	10/12/08	Common Stock	140,285.000		258,210.000	D	

Explanation of Responses:

(1) The option becomes exercisable in 25 percent increments on October 12, 1998, June 30, 1999, 2000, and 2001, respectively.

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

Ken L. Harrison
**Signature of Reporting Person

11/05/98
Date

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*

HARRISON (Last) KEN L. (First) (Middle)

121 S.W. SALMON STREET (Street)

PORTLAND (City) OR (State) 97204 (Zip)

2. Issuer Name and Ticker or Trading Symbol
ENRON CORP. (ENE)

3. IRS or Social Security Number of Reporting Person (Voluntary)

4. Statement for Month/Year
February 1999

5. If Amendment, Date of Original (Month/Year)

6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
X Director ___ 10% Owner
X Officer (give title below) ___ Other (specify below)
VICE CHAIRMAN

7. Individual or Joint/Group Filing (Check Applicable)
X Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	01/31/99	I	V	1,630.00	D	$66.0000		D	
Common Stock	02/24/99	M		27,000.00	A	$16.0305		D	
Common Stock	02/24/99	S		27,000.00	D	$67.9157	58,060.00	D	
Common Stock							8,086.11	I	by 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

* If the form filed by more than one reporting person

(Over)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock ~tion (right to buy)	$16.0305	02/24/99	M			27,000.00	10/02/95	10/02/00	Common Stock	27,000.00		50,000.00	D	

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

Ken L. Harrison
**Signature of Reporting Person

3/4/99
Date

Exhibit 8 - Page 1 of 2
Memo in Supp of Ken L. Harrison's Mo to Dismiss

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	X Director ___ 10% Owner X Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary)	VICE CHAIRMAN
PORTLAND OR 97204 (City) (State) (Zip)	4. Statement for Month/Year: April 1999 5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I -- Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	04/30/99	M		50,000.00	A	$16.0305		D	
Common Stock	04/30/99	S		50,000.00	D	$75.0000	58,060.00	D	
Common Stock							8,086.11	I	by 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly
* If the form filed by more than one reporting person see Instruction 4(b)(v).

(Over)
SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$16.0305	04/30/99	M			50,000.00	10/02/95	10/02/00	Common Stock	50,000.00		0.00	D	

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

**Signature of Reporting Person

5-3-99
Date

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*

HARRISON KEN L.
(Last) (First) (Middle)

121 S.W. SALMON STREET
(Street)

PORTLAND OR 97204
(City) (State) (Zip)

2. Issuer Name and Ticker or Trading Symbol

ENRON CORP. (ENE)

3. IRS or Social Security Number of Reporting Person (Voluntary)

4. Statement for Month/Year

January 1900

5. If Amendment, Date of Original (Month/Year)

6. Relationship of Reporting Person(s) to Issuer (Check all applicable)

X Director ____ 10% Owner
____ Officer (give title below) ____ Other (specify below)

7. Individual or Joint/Group Filing (Check Applicable)

X Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	06/25/99	A	V	97,405.00	A	$0.00		D	
Common Stock	10/11/99	D	V	194,810.00	D	$0.00		D	
Common Stock	01/31/00	F	V	4,739.00	D	$67.87		D	
Common Stock	01/31/00	F	V	2,482.00	D	$67.87	108,833.00	D	
Common Stock							16,359.03	I	by 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

(Over)

* If the form filed by more than one reporting person, see Instruction 4(b)(v).

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$77.00	06/25/99	A	V	446,155.00		(1)	06/25/06	Common Stock	446,155.00		446,155.00	D	

Explanation of Responses:

(1) The option becomes exercisable in 33 percent increments on December 31, 1999, 2000 and 2001, respectively.

- On August 13, 1999, the common stock of Enron Corp. split 2-for-1. The number of shares owned and the number of any options held at the end of the month have been increased to reflect this stock split. All pre-split option prices previously reported in Table II, have been adjusted downward by one half to reflect the effect of the stock split.

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations.
See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

**Signature of Reporting Person

2/8/00
Date

Exhibit 10 - Page 1 of 2
Memo in Supp of Ken L.
Harrison's Mo to Dismiss

FORM 4

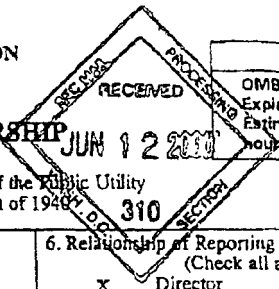
☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940



OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENR)	X Director ___ 10% Owner ___ Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary) / 4. Statement for Month/Year: May 2000	
PORTLAND OR 97204 (City) (State) (Zip)	5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	04/01/00	F	V	8,012.00	D	$74.87		D	
Common Stock	04/01/00	F	V	21,515.00	D	$74.87		D	
Common Stock	05/02/00	M		56,500.00	A	$20.78		D	
Common Stock	05/02/00	S		56,500.00	D	$74.07		D	
Common Stock	05/02/00	M		14,860.00	A	$20.78		D	
Common Stock	05/02/00	S		14,860.00	D	$74.07		D	
Common Stock	05/02/00	M		189,830.00	A	$20.72		D	
Common Stock	05/02/00	S		189,830.00	D	$76.07		D	
Common Stock	05/02/00	M		10,170.00	A	$20.78		D	
Common Stock	05/02/00	S		10,170.00	D	$76.07		D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly
* If the form filed by more than one reporting person, see Instruction 4(b)(v).

(Over)
SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$20.72	05/02/00	M			189,830.00	04/01/00	07/01/07	Common Stock	189,830.00			D	
Employee Non-Qualified Stock Option (right to buy)	$20.72	05/11/00	M			50,170.00	04/01/00	07/01/07	Common Stock	50,170.00		0.00	D	
Employee Non-Qualified Stock Option (right to buy)	$20.78	05/02/00	M			56,500.00	04/01/00	12/31/04	Common Stock	56,500.00			D	
Employee Non-Qualified Stock Option (right to buy)	$20.78	05/02/00	M			10,170.00	04/01/00	12/31/04	Common Stock	10,170.00		0.00	D	
Employee Non-Qualified Stock Option (right to buy)	$20.78	05/02/00	M			14,860.00	04/01/00	12/31/07	Common Stock	14,860.00		0.00	D	
Employee Non-Qualified Stock Option (right to buy)	$20.66	05/02/00	M			28,640.00	01/19/98	01/19/05	Common Stock	28,640.00		0.00	D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/11/00	M			49,830.00	10/12/98	10/12/08	Common Stock	49,830.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/12/00	M			15,000.00	10/12/98	10/12/08	Common Stock	15,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/15/00	M			20,000.00	06/30/99	10/12/08	Common Stock	20,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/16/00	M			65,000.00	04/01/00	10/12/08	Common Stock	65,000.00		366,590.00	D	

Explanation of Responses:

(1) 25% of shares become exercisable on February 28, 2000, and 25% on January 18, 2001, 2002 and 2003, respectively.

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations.
See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

**Signature of Reporting Person

Date

Exhibit 11 - Page 1 of 2
Memo in Supp of Ken L. Harrison's Mo to Dismiss

FORM 4 continued

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL
OMB Number: 3235-0287
Expires: September 30, 1998
Estimated average burden hours per response 0.5

RECEIVED JUN 12 2000

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship(s) of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	____ Director ____ 10% Owner ____ Officer (give title below) ____ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary)	4. Statement for Month/Year: May 2000
PORTLAND OR 97204 (City) (State) (Zip)		5. If Amendment, Date of Original (Month/Year)
		7. Individual or Joint/Group Filing (Check Applicable) ___ Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	05/02/00	M		26,640.00	A	$20.06		D	
Common Stock	05/02/00	S		26,640.00	D	$74.07		D	
Common Stock	05/11/00	M		50,170.00	A	$20.72		D	
Common Stock	05/11/00	S		50,170.00	D	$78.00		D	
Common Stock	05/11/00	M		49,830.00	A	$25.47		D	
Common Stock	05/11/00	M		49,830.00	D	$78.00		D	
Common Stock	05/12/00	M		15,000.00	A	$25.47		D	
Common Stock	05/12/00	S		15,000.00	D	$78.00		D	
Common Stock	05/15/00	M		20,000.00	A	$25.47		D	
Common Stock	05/15/00	S		20,000.00	D	$78.13		D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly
* If the form filed by more than one reporting person, see Instruction 4(b)(v).

(Over)
SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$62.50	02/07/00	B	V	50.00		(1)	02/07/07	Common Stock	50.00		50.00	D	

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations.
See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number

**Signature of Reporting Person

Date

Exhibit 12 - Page 1 of 2
Memo in Supp of Ken L. Harrison's Mo to Dismiss

FORM 4 continued

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

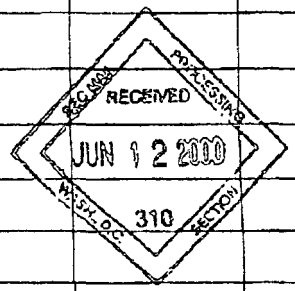
STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	___ Director ___ 10% Owner ___ Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary) / 4. Statement for Month/Year: May 2000	
PORTLAND OR 97204 (City) (State) (Zip)	5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) ___ Form filed by One Reporting Person ___ Form filed by More than One Reporting Person

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	05/16/00	M		65,000.00	A	$25.47		D	
Common Stock	05/16/00	S		65,000.00	D	$78.17	79,312.00	D	
Common Stock							16,397.44	I	by 401(k) Plan



Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

* If the form filed by more than one reporting person, see Instruction 4(b)(v).

(Over)

SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed.
If space provided is insufficient, See Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays the currently valid OMB Number.

K. L. Harrison
**Signature of Reporting Person

6/6/00
Date

Exhibit 13 - Page 1 of 2
Memo in Supp of Ken L. Harrison's Mo to Dismiss

FORM 4

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

UNITED STATES SECURITIES EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

OMB AI	AL
OMB Number:	3235-0287
Expires:	September 30, 1998
Estimated average burden hours per response	0.5

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L.	ENRON CORP. (ENE)	X Director ___ 10% Owner
(Last) (First) (Middle)	3. IRS or Social Security Number of Reporting Person (Voluntary)	___ Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET	4. Statement for Month/Year: August 2000	
(Street)	5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable)
PORTLAND OR 97204		X Form filed by One Reporting Person
(City) (State) (Zip)		___ Form filed by More than One Reporting Person

Table I -- Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	08/28/00	M		32,000.00	A	$25.47		D	
Common Stock	08/28/00	S		32,000.00	D	$86.69		D	
Common Stock	08/29/00	M		68,000.00	A	$25.47		D	
Common Stock	08/29/00	S		68,000.00	D	$87.20		D	
Common Stock	08/29/00	M		30,740.00	A	$25.47		D	
Common Stock	08/29/00	S		30,740.00	D	$86.88		D	
Common Stock	08/29/00	M		29,260.00	A	$25.47		D	
Common Stock	08/29/00	S		29,260.00	D	$86.88	79,312.00	D	
Common Stock							16,375.88	I	by 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly

* If the form filed by more than one reporting person, see Instruction 4(b)(v).

(Over)

SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$25.47	08/28/00	M			32,000.00	04/01/00	10/12/08	Common Stock	32,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	08/29/00	M			68,000.00	04/01/00	10/12/08	Common Stock	68,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	08/29/00	M			30,740.00	04/01/00	10/12/08	Common Stock	30,740.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	08/29/00	M			29,260.00	04/01/00	10/12/08	Common Stock	29,260.00		206,590.00	D	

Explanation of Responses:

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

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**Signature of Reporting Person

9-4-00
Date

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	September 30, 1998
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☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

(Print or Type Responses)

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(f) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	6. Relationship of Reporting Person(s) to Issuer (Check all applicable)
HARRISON KEN L. (Last) (First) (Middle)	ENRON CORP. (ENE)	X Director ___ 10% Owner ___ Officer (give title below) ___ Other (specify below)
121 S.W. SALMON STREET (Street)	3. IRS or Social Security Number of Reporting Person (Voluntary) / 4. Statement for Month/Year: September 2000 / 5. If Amendment, Date of Original (Month/Year)	7. Individual or Joint/Group Filing (Check Applicable) X Form filed by One Reporting Person ___ Form filed by More than One Reporting Person
PORTLAND (City) OR (State) 97204 (Zip)		

Table I – Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned at End of Month (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
		Code	V	Amount	(A) or (D)	Price			
Common Stock	09/01/00	M		40,000.00	A	$25.47		D	
Common Stock	09/01/00	S		40,000.00	D	$86.91		D	
Common Stock	09/18/00	M		100,000.00	A	$25.47		D	
Common Stock	09/18/00	S		100,000.00	D	$89.43		D	
Common Stock	09/18/00	M		33,410.00	A	$38.50		D	
Common Stock	09/18/00	S		33,410.00	D	$89.44		D	
Common Stock	09/18/00	M		56,590.00	A	$25.47		D	
Common Stock	09/18/00	S		56,590.00	D	$89.44	79,312.00	D	
Common Stock							16,358.72	I	by 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly
* If the form filed by more than one reporting person, see Instruction 4(b)(v).

(Over)
SEC 1474 (7-96)

FORM 4 (continued)

Table II – Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8 Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Beneficially Owned at End of Month (Instr. 4)	10. Ownership Form of Derivative Security: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Non-Qualified Stock Option (right to buy)	$15.47	05/01/00	M			40,000.00	04/01/00	10/12/08	Common Stock	40,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/18/00	M			100,000.00	04/01/00	10/12/08	Common Stock	100,000.00			D	
Employee Non-Qualified Stock Option (right to buy)	$25.47	05/18/00	M			66,590.00	04/01/00	10/12/08	Common Stock	66,590.00		0.00	D	
Employee Non-Qualified Stock Option (right to buy)	$38.50	05/16/00	M			33,410.00	12/31/99	06/25/06	Common Stock	33,410.00		412,745.00	D	

Explanation of Responses:

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K L Harrison
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TEXT

2001 OREGON REVISED STATUTES
TITLE 57. UTILITY REGULATION
CHAPTER 756. PUBLIC UTILITY COMMISSION. GENERAL PROVISIONS
COMMISSION POWERS AND DUTIES
(GENERALLY)

756.040. General powers.

(1) In addition to the powers and duties now or hereafter transferred to or vested in the Public Utility Commission, the commission shall represent the customers of any public utility or telecommunications utility and the public generally in all controversies respecting rates, valuations, service and all matters of which the commission has jurisdiction. In respect thereof the commission shall make use of the jurisdiction and powers of the office to protect such customers, and the public generally, from unjust and unreasonable exactions and practices and to obtain for them adequate service at fair and reasonable rates. The commission shall balance the interests of the utility investor and the consumer in establishing fair and reasonable rates. Rates are fair and reasonable for the purposes of this subsection if the rates provide adequate revenue both for operating expenses of the public utility or telecommunications utility and for capital costs of the utility, with a return to the equity holder that is:

(a) Commensurate with the return on investments in other enterprises having corresponding risks; and

(b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital.

(2) The commission is vested with power and jurisdiction to supervise and regulate every public utility and telecommunications utility in this state, and to do all things necessary and convenient in the exercise of such power and jurisdiction.

(3) The commission may participate in any proceeding before any public officer, commission or body of the United States or any state for the purpose of representing the public generally and the customers of the services of any public utility or telecommunications utility operating or providing service to or within this state.

(4) The commission may make joint investigations, hold joint hearings within or without this state and issue concurrent orders in conjunction or concurrence with any official, board, commission or agency of any state or of the United States.

CREDIT

(Amended by 1961 c. 467 s 1; 1971 c. 655 s 9; 1973 c. 776 s 15; 1987 c. 447 s 76; 1995 c. 733 s 53; 2001 c. 569 s 1)

<General Materials (GM) - References, Annotations, or Tables>

Citation | Found Document | Rank(R) 1 of 1 | Database
OR ST S 757.120 | | | OR-ST-ANN
O.R.S. s 757.120

TEXT

2001 OREGON REVISED STATUTES
TITLE 57. UTILITY REGULATION
CHAPTER 757. UTILITY REGULATION GENERALLY. GENERAL PROVISIONS
BUDGET, ACCOUNTS AND REPORTS OF UTILITIES

Current through End of 2001 Reg. Sess. and 2001 Cumulative Supp.

757.120. Accounts required.

(1) Every public utility shall keep and render to the Public Utility Commission, in the manner and form prescribed by the commission, uniform accounts of all business transacted. All forms of accounts which may be prescribed by the commission shall conform as nearly as practicable to similar forms prescribed by federal authority.

(2) Every public utility engaged directly or indirectly in any other business than that of a public utility shall, if required by the commission, keep and render separately to the commission, in like manner and form, the accounts of all such other business, in which case all the provisions of this chapter shall apply with like force and effect to the accounts and records of such other business.

CREDIT

(Amended by 1971 c. 655 s 85)

<General Materials (GM) - References, Annotations, or Tables>

O. R. S. s 757.120
OR ST s 757.120
END OF DOCUMENT

United States District Court, N.D. Texas, Dallas Division.

Raffaele BRANCA, Carl C. Conrad, and Michael P. Fuchs, et al., Plaintiffs,
v.
PAYMENTECH, INC., F/K/A First USA Paymentech, Inc., Pamela H. Patsley, and David W. Truetzel, Defendants.

No. Civ.A.3:97-CV-2507-L.

Feb. 8, 2000.

MEMORANDUM OPINION AND ORDER

LINDSAY, J.

*1 Before the court is Defendants' Motion to Dismiss Plaintiffs' Second Amended Class Action Complaint, filed November 20, 1998. After careful consideration of the motion, response, reply, the voluminous supplemental filings submitted by the parties, and the applicable law, the court grants Defendants' Motion to Dismiss and dismisses Plaintiffs' claims with prejudice.

I. *Factual and Procedural Background*

Plaintiffs are a class of persons who purchased common stock of Defendant Paymentech, Inc. ("Paymentech") during the period between January 22, 1997 and September 24, 1997. Paymentech is a corporation whose business involves the processing of electronic payments. Paymentech's business includes processing bank card transactions, issuing commercial card products, processing commercial card payments and information, and providing third-party credit and debt authorization services to financial institutions, sales agents, and merchants. Defendant Pamela Patsley ("Patsley") was President and Chief Executive Officer of Paymentech during the class period. Patsley is a CPA who worked for a large accounting firm before joining Paymentech. Defendant David Truetzel ("Truetzel") served as Paymentech's Chief Financial Officer and Secretary during the class period.

Plaintiffs allege that during the class period, Paymentech issued false and misleading statements concerning its second, third, and fourth quarter 1997 financial results. These statements were purportedly made to "create the appearance of growth" and meet analyst expectations, thus artificially inflating the price of Paymentech's stock. Plaintiffs allege that in addition to benefitting the Defendants directly, the inflated stock price also helped ensure the closing a merger between Paymentech, First USA, Inc. ("First USA") and Banc One Corporation ("Banc One") (the "Merger"). According to Plaintiffs, Paymentech was not yielding the revenue and income growth that it represented when it reported record results and continued growth. Plaintiffs maintain that Paymentech's financial health was overstated due to gains it achieved on undisclosed, one-time, unusual and related-party transactions in the last three quarters of the 1997 fiscal year. Plaintiffs further contend that Paymentech overstated its fourth-quarter and year-end results because it failed to record an additional $21.5 million in pre-tax charges and other expenses. Defendants later revealed these facts, which showed that Paymentech had actually incurred a loss in the fourth quarter of 1997.

Plaintiffs also have alleged claims based on statements made by Defendants with respect to the impact of the Merger on Paymentech. Prior to the Merger, Paymentech was a majority-owed subsidiary of First USA. They contend that Paymentech's business was already stagnating and that the Merger had a negative effect on Paymentech's business. Defendants maintained that the Merger would have no effect on Paymentech's customer relationships, but Plaintiffs state that the Merger negatively impacted Paymentech because its new majority shareholder was Banc One, a competitor of many of Paymentech's customers. According to Plaintiffs, these customers were reluctant to share their confidential information with Paymentech in light of Paymentech's new ownership.

*2 On September 24, 1997, Paymentech negatively revised its financial results and disclosed problems related to its core business. Paymentech's stock price tumbled to $16 3/8 per share from $34 1/8 per share at the beginning of the class period. Plaintiffs filed this lawsuit on October 10, 1997, alleging claims under sections 10(b) and 20(a) of the

Securities Exchange Act of 1934 (the "Exchange Act"), codified in relevant part at 15 U.S.C. §§ 78j(b) and 78t(a). This is Plaintiffs' third attempt to plead their case. Plaintiffs have amended their pleadings twice since they originally filed this lawsuit, filing an amended complaint on April 6, 1998, and again amending their pleadings on September 2, 1998. Defendants now move to dismiss Plaintiffs' Second Amended Class Action Complaint ("Complaint") filed September 2, 1998.

II. *Applicable Pleading Standards*

Defendants move to dismiss the Complaint for failure to state a claim under Fed.R.Civ.P. 12(b)(6) , for failure to plead fraud with particularity pursuant to Fed.R.Civ.P. 9(b), and for failure to adequately plead scienter as required by the Private Securities Litigation Reform Act of 1995 ("PSLRA").

A. *Pleading Requirements of Rules 12(b)(6), 9(b) and the PSLRA*

The court cannot dismiss Plaintiffs' claims under Rule 12(b)(6) unless it appears beyond doubt that they can prove no set of facts entitling them to relief. *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957) ; *Coates v. Heartland Wireless Communications, Inc.,* 26 F.Supp.2d 910, 913-14 (N.D.Tex.1998) (*"Coates I"*). The Plaintiffs' factual allegations are accepted as true when considering a Rule 12(b)(6) motion to dismiss. *Buckley v. Fitzsimmons,* 509 U.S. 259, 261 (1993); *Blackburn v. City of Marshall,* 42 F.3d 925, 931 (5 th Cir.1995). The court, however, will not accept conclusory allegations in the complaint as true. *Kaiser Aluminum & Chem. Sales, Inc. v. Avondale Shipyards, Inc.,* 677 F.2d 1045, 1050 (5 th Cir.1982), *cert. denied,* 459 U.S. 1105 (1983); *Robertson v. Strassner,* 32 F.Supp.2d 443, 445 (S.D.Tex.1998); *Zuckerman v. Faxmeyer Health Corp.,* 4 F.Supp.2d 618, 621 (N.D.Tex.1998).

To survive dismissal, Plaintiffs must have alleged facts that show they are entitled to relief on their substantive causes of action. Section 10(b) of the Exchange Act makes it unlawful for a person to:

> use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). In relevant part, Rule 10b-5 makes it unlawful for any person, directly or indirectly, to:

> make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security.

***3** 17 C.F.R. § 240.10b-5. To state a claim for securities frand in violation of section 10(b) and Rule 10b-5, a plaintiff must allege (1) a misrepresentation or omission; (2) of a material fact; (3) made with the intent to defraud; (4) on which the plaintiff relied; and (5) which proximately caused the plaintiff's injury. *Williams v. WMX Technologies, Inc.,* 112 F.3d 175, 177 (5 th Cir.1997); *Tuchman v. DSC Communications Corp.,* 14 F.3d 1061, 1067 (5 th Cir.1994); *Cyrak v. Lemon,* 919 F.2d 320, 325 (5 th Cir.1990). In cases such as this one, where a plaintiff alleges a "fraud on the market" theory, it is not necessary for the plaintiff to prove individual reliance on the false or misleading statement. *In re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1112-14 (9 th Cir.1989), *cert. denied,* 496 U.S. 943 (1990); *Coates I,* 26 F.Supp.2d at 914 n. 1; *Zuckerman,* 4 F.Supp.2d at 621. Instead, a plaintiff may show that he indirectly relied on the statements by relying on the integrity of the market price of the stock. *Id.*

Because section 10(b) claims are fraud claims, the plaintiff must also satisfy the pleading requirements imposed by Fed.R.Civ.P. 9(b). *Melder v. Morris,* 27 F.3d 1097, 1100 (5 th Cir.1994); *Tuchman,* 14 F.3d at 1067. Rule 9(b) requires certain minimum allegations in a securities fraud case, namely the specific time, place, and contents of the false representations, along with the identity of the person making the false representation and what the person obtained thereby. *Melder,* 27 F.3d at 1100; *Shushany v. Allwaste, Inc.,* 992 F.2d 517, 521 (5 th Cir.1993). This application of the heightened pleading standard of Rule 9(b) provides defendants with fair notice of the plaintiffs' claims, protects them from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims and then attempting to discover unknown wrongs. *Melder,* 27

F.3d at 1100; *Tuchman,* 14 F.3d at 1067.

The PSLRA has further reinforced this particularity requirement with respect to pleading securities fraud claims. *Coates I,* 26 F.Supp.2d at 914. The PSLRA provides that

> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). To satisfy Rule 9(b) and the PSLRA, a plaintiff must plead specific facts and avoid reliance on conclusory allegations. *Tuchman,* 14 F.3d at 1067; *Coates I,* 26 F.Supp.2d at 915. The PSLRA further requires that any allegations on information and belief that a particular statement is misleading or fraudulent must state with particularity all facts on which that belief is formed. 15 U.S.C. § 78u-4(b)(1); *Robertson,* 32 F. Supp .2d at 446; *Coates I,* 26 F.Supp.2d at 915.

***4** Plaintiffs' second claim alleges violations of section 20(a) of the Exchange Act. This section defines controlling person liability, providing that:

> [e]very person who, directly or indirectly, controls any person liable under any provision of this chapter ... shall also be liable jointly and severally with and to the same extent as such controlled person....

15 U.S.C. § 78t(a). Where a primary violation by the "controlled person" has not been adequately pleaded, the court should also dismiss a section 20(a) claim. *Coates I,* 26 F.Supp.2d at 923.

B. *Scienter Requirement*

In addition to the aforementioned pleading requirements, plaintiffs asserting securities fraud claims must allege facts demonstrating scienter. *Lovelace v. Software Spectrum, Inc.,* 78 F.3d 1015, 1018 (5 th Cir.1996); *Tuchman,* 14 F.3d at 1068; *Zuckerman,* 4 F.Supp.2d at 622. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976); *Lovelace,* 78 F.3d at 1018. To adequately plead scienter, the plaintiff must set forth specific facts to support an inference of fraud. *Lovelace,* 78 F.3d at 1018; *Tuchman,* 14 F.3d at 1068. The PSLRA requires that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). When a complaint fails to plead scienter in conformity with the PSLRA, dismissal is required. 15 U.S.C. § 78u-4(b)(3)(A); *Coates v. Heartland Wireless Communications, Inc.,* 55 F.Supp.2d 628, 634 (N.D.Tex.1999) (*"Coates II"*).

Since the enactment of the PSLRA, its effect upon previously-established standards for pleading scienter has been debated in the federal courts. This case is no different. Here, Plaintiffs urge the court to affirm the use of the Second Circuit's well-entrenched test for determining whether scienter has been properly pleaded. [FN1] Under this standard, a securities fraud plaintiff may adequately plead a "strong inference" of scienter by (1) identifying circumstances indicating conscious or reckless behavior by defendants; or (2) allege facts showing a motive to commit fraud and a clear opportunity to do so. *In re Time Warner, Inc. Sec. Litig.,* 9 F.3d 259, 269 (2d Cir.1993), *cert. denied,* 511 U.S. 1017 (1994); *Robertson,* 32 F.Supp.2d at 447 n. 4. Pre-PSLRA, the Fifth Circuit adopted and applied this standard to section 10(b) claims. *Tuchman,* 14 F.3d 1061 at 1068; *Coates II,* 55 F.Supp.2d at 642; *Zuckerman,* 4 F.Supp.2d at 622. Plaintiffs argue that this standard survived the enactment of the PSLRA, and that therefore they can survive dismissal here by showing either conscious behavior or recklessness, or motive and opportunity to commit fraud. While the Fifth Circuit has not squarely confronted this issue, [FN2] a number of courts both in and out of this circuit have agreed with Plaintiffs' position. *See, e.g., In re Advanta Corp. Securities Litigation,* 180 F.3d 525, 534-35 (3d Cir.1999); *Press v. Chemical Investment Svcs. Corp.,* 166 F.3d 529, 537-38 (2d Cir.1999); *Coates II,* 55 F.Supp.2d at 642; *Robertson,* 32 F.Supp.2d at 447; *Zuckerman,* 4 F.Supp.2d at 623; *STI Classic Fund v. Bollinger Industries, Inc.,* 1996 WL 885802 (N.D.Tex.1996).

FN1. Plaintiffs' Brief in Opposition to Defendants' Motion to Dismiss Plaintiffs' Second Amended Class Action Complaint ("Plaintiffs' Brief") at p. 10.

FN2. The PSLRA did not govern in *Williams,* a Fifth Circuit case that was filed prior to its effective date.

112 F.3d at 178. Although the PSLRA was not implicated in that case, the court did express, in dicta, its opinion that the PSLRA adopted the same pleading standard previously applied by the Fifth Circuit. *Id.*

***5** Not surprisingly, Defendants take the opposite position, maintaining that the continued validity of the motive and opportunity test is "questionable" following the enactment of the PSLRA, and that a heightened pleading standard became effective when the PSLRA was adopted. [FN3] Although they recognize that the Fifth Circuit has yet to consider the issue, Defendants correctly note that a number of courts have held that a strong inference of scienter can no longer be raised by alleging nothing more than motive and opportunity to commit fraud. [FN4] The court's own research, in addition to the supplemental filings submitted by the parties, reveals that since the parties originally briefed the issue, several courts of appeal have reached the same conclusion. *See, e.g., In re Comshare, Inc. Securities Litigation,* 183 F.3d 542, 551 (6 th Cir.1999) (facts showing motive and opportunity are inadequate to establish scienter where it is not also shown that defendant acted knowingly, recklessly, or with the requisite state of mind); *In re Silicon Graphics Inc. Securities Litigation,* 183 F.3d 970, 979 (9 th Cir.1999) (Congress rejected motive and opportunity test in favor of higher pleading standard requiring "deliberate recklessness"); *Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1283 (11 th Cir.1999) (PSLRA did not codify the motive and opportunity test); *Greebel v. FTP Software, Inc.,* 194 F.3d 185, 197 (1 st Cir.1999) (pleading motive and opportunity does not satisfy requirements of PSLRA). *See also In re Paracelsus Corp. Sec. Litig.,* 61 F.Supp.2d 591, 598 (S.D.Tex.1998) (same).

FN3. Brief in Support of Defendants' Motion to Dismiss Plaintiffs' Second Amended Class Action Complaint ("Defendants' Brief") at pp. 8-9.

FN4. *Id.* at p 9, *citing In re Glenayre Technologies, Inc. Sec. Litig.,* 982 F.Supp. 294, 298 (S.D.N.Y.1997); *Novak v. Kasaks,* 997 F.Supp. 425, 430 (S.D.N.Y.1998); *In re Baesa Sec. Litig.,* 969 F.Supp. 238, 242 (S.D.N.Y.1997).

While it is true that Congress did not codify the motive and opportunity test in the body of the PSLRA, the court holds that a plain reading of the statute does not preclude its use as a pleading standard in a section 10(b) case. To determine whether Congress intended to adopt a particular pleading standard when it enacted the PSLRA, the court first looks to the plain language of the statute. *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 570 (1982); *United Svcs. Automobile Assn. v. Perry,* 102 F.3d 144, 146-47 (5 th Cir.1996). Absent any contrary definition, the court assumes that Congress intended the words in the statute "to carry their ordinary, contemporary, common meaning." *United States v. Gray,* 96 F.3d 769, 774 (5 th Cir.1996), *cert. denied,* 520 U.S. 1129 (1997); *Robertson,* 32 F.Supp.2d at 447-48. The language of section 78u-4(b)(2) simply does not restrict Plaintiffs to a particular standard of pleading; rather, it only requires that they "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The statute does not elaborate further on this language, or purport to alter any evidentiary standards that previously applied to section 10(b) claims.

Prior to the adoption of the PSLRA, the Fifth Circuit permitted the pleading of scienter by allegations showing motive and opportunity to commit fraud. *Tuchman,* 14 F.3d at 1068. Because the PSLRA did not amend or alter existing pleading standards, the court joins those other courts who have recognized the continuing validity of the motive and opportunity test for pleading scienter. *See, e.g., Advanta.* 180 F.3d at 534-35; *Press,* 166 F.3d at 537-38; *Coates II,* 55 F.Supp.2d at 642; *Robertson,* 32 F.Supp.2d at 447; *Zuckerman,* 4 F.Supp.2d at 623; *STI Classic Fund,* 1996 WL 885802 at *1; *Epstein v. Itron, Inc.,* 993 F.Supp. 1314, 1320-22 (E.D.Wash.1998). Therefore, where facts showing motive and opportunity to commit fraud raise a "strong inference that the defendant acted with the required state of mind," the PSLRA's pleading requirements are satisfied and dismissal is not warranted. The court will apply the motive and opportunity standard in its analysis of Plaintiffs' Second Amended Complaint ("Complaint").

III. *Defendants' Motion to Dismiss*

***6** Defendants move to dismiss Plaintiffs' Complaint, contending that the Complaint is deficient because it does not satisfy the particularity

requirements of the PSLRA and Rule 9(h), and additionally because Plaintiffs have not adequately pleaded facts raising a strong inference of scienter. Each of these contentions will be addressed separately below.

A. *Particularity Requirements of the PSLRA*

If allegations regarding an alleged misstatement or omission are based on information and belief, the plaintiff must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Defendants argue that Plaintiffs have failed to state with particularity all facts upon which their information and belief pleading is based, and that therefore the court should dismiss Plaintiffs' Complaint pursuant to 15 U.S.C. § 78u-4(b)(3)(A). In the Complaint, Plaintiffs state that the allegations pertaining to themselves and their counsel are made on personal knowledge, and that all other allegations in the Complaint are "based upon the investigation undertaken by and under the supervision of plaintiffs' counsel." [FN5] Plaintiffs describe the investigation and the sources of their information as follows:

FN5. Complaint at p. 1.

[t]his investigation included, among other things, a review of public filings by Paymentech, Inc., ... with the SEC, analyst reports concerning the Company, information concerning the trading of the Company's stock, press releases issued by the Company, media reports about the Company, meetings with consultants, and the review and analysis of documents filed with the Judicial District Court in Dallas County, Texas in the matter of *First USA Management Resources, Inc. et al. v. Golder Thoma Cressey Fund III. L.P.*, Cause No. DV- 998-00413 (Dallas Co. TX June 1998). Plaintiffs believe that further substantial evidentiary support will exist for the allegations set forth below after a reasonable opportunity for discovery. [FN6]

FN6. *Id.* at pp. 1-2.

This statement, as set forth in the initial paragraphs of Plaintiffs' Complaint, establishes that Plaintiffs have pled their case mainly on information and belief, as permitted by the Federal Rules of Civil Procedure. Fed.R.Civ.P. 11(b) (pleading permitted based on a person's knowledge, or information and belief, formed after "reasonable inquiry"). [FN7] The Complaint is thus subject to the requirements presented by the PSLRA, specifically section 78u-4(b)(1), which requires that all facts supporting information and belief allegations be stated with particularity.

FN7. The court notes that other courts have held that pleading based on "investigation of counsel" is the equivalent of pleading based on personal knowledge. *See In re PETsMART, Inc. Sec. Litig.*, 61 F.Supp.2d 982, 989 (D.Ariz.1999); *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F.Supp.2d 1345, 1354 (D.Colo.1998). These courts have held litigants who allege facts based on "investigation of counsel" to a pleading standard requiring even higher particularity by identifying (1) each misleading statement; (2) the reason or reasons why the statement is misleading; and (3) as to each statement, those facts giving rise to a strong inference that the defendants acted with scienter. *Id.* Here, the statement made in the Complaint concerning counsel's investigation is strikingly similar to that made in the complaint at issue in *PETsMART*. 61 F.Supp.2d at 989 n. 2, which raises the question of whether the heightened standard should similarly be applied in this case. Although the court does not necessarily agree with those courts that have held that the "investigation of counsel" is tantamount to personal knowledge, the court need not reach this question because the Complaint in this case specifically states that the only allegations based on personal knowledge are those pertaining to Plaintiffs and their counsel, Complaint at p. 1. Therefore, the court will presume that Plaintiffs intended to plead the remaining factual allegations based on information and belief and will not consider holding Plaintiffs to the higher standard imposed when facts are pleaded based on personal knowledge.

Defendants contend that Plaintiffs have not satisfied the PSLRA's standard for pleading facts based on information and belief. Specifically, Defendants argue that Plaintiffs' description of their counsel's investigation in this case constitutes no more than a boilerplate allegation that does not satisfy the particularity requirement of 15 U.S.C. § 78u-4(b)(1) . According to Defendants, Plaintiffs should be required to specifically identify the public filings, reports, and press releases they reviewed, as well as the consultants they worked with in forming their

beliefs. Defendants also maintain that Plaintiffs should be required to describe in the Complaint all other steps they took in the course of their investigation.

***7** Plaintiffs respond that they have sufficiently stated particular facts upon which their information and belief allegations are formed. The court agrees that with respect to Defendants' various statements and public filings concerning Paymentech's financial results, Plaintiffs have adequately pleaded with particularity those facts that cause them to believe Defendants' statements were untrue. Specifically, the Complaint identifies the September 24, 1997 press release announcing the revisions made to Paymentech's financial results. [FN8] Plaintiffs' identification of this specific statement is adequate to establish the basis of their information and belief regarding the alleged falsity of Defendants' prior statements regarding Paymentech's profits and earnings. *Coates I,* 926 F.Supp.2d at 917.

FN8. Complaint at ¶ 57.

With respect to the other statements in the Complaint, the court finds that Plaintiffs have not pleaded with sufficient particularity the facts supporting their information and belief allegations. The PSLRA requires Plaintiffs to plead particular facts that have led them to believe that the statements identified by Plaintiffs as material misrepresentations are indeed untrue. Although Plaintiffs' long-winded and detailed 60-page Complaint identifies numerous statements (other than the statements regarding Paymentech's financial results) allegedly made by Defendants in various public filings, press releases, and in other contexts, Plaintiffs have not met their duty to plead "with particularity" the facts supporting their belief that these statements are actually misrepresentations that are actionable under section 10(b). Plaintiffs' general statement that the allegations in the Complaint are based on public filings, news articles, press releases, analyst reports, and meetings with consultants does not sufficiently identify the facts upon which Plaintiffs' beliefs are based. *Coates I,* 26 F.Supp.2d at 917; *Novak,* 997 F.Supp. at 431. Plaintiffs have not identified the particular articles, releases, filings, documents, or other information, including the substance of the meetings with their consultants, that would support their allegations that Defendants made false representations in violation of section 10(b). For this reason, dismissal of Plaintiffs' Complaint is mandated by the PSLRA. 15 U.S.C. § 78u-4(b)(3)(A); *McNamara v. Bre-X Minerals Ltd.,* 57 F.Supp. 396, 405 (E.D.Tex.1999); *Paracelsus,* 61 F.Supp.2d at 595; *Coates I,* 26 F.Supp.2d at 923.

B. *Rule 9(b) Pleading Requirements*

Plaintiffs' securities fraud claims are also subject to the special pleading requirements found in Fed.R.Civ.P. 9(b), which requires them to plead their fraud claim with particularity. Pleading fraud with particularity requires a party to "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent. *Williams,* 112 F.3d at 177-78; *Tuchman,* 14 F.3d at 1068. With few exceptions, the Complaint alleges somewhat vague and conclusory allegations against "defendants" or "Paymentech and the Individual Defendants". [FN9] These statements do not identify the speaker and instead constitute an attempt to use "group pleading" in order to allege fraud. Under the "group pleading" doctrine, plaintiffs may rely on a presumption that statements in prospectuses, press releases, and other company-generated documents are the collective work of those individuals directly involved in the company's daily management. *Coates I,* 26 F.Supp.2d at 915.

FN9. *See, e.g.* Complaint at ¶¶ 27, 28, 36, 37, 43, 51.

***8** Whether the group pleading doctrine is still viable under the PSLRA is currently a matter of debate. Several courts have held that group pleading survives the enactment of the PSLRA. *See In re Miller Indus., Inc. Sec. Litig.,* 12 F.Supp.2d 1323, 1329 (N.D.Ga.1998); *In re Stratosphere Corp. Sec. Litig.,* 1 F.Supp.2d 1096, 1108 (D.Nev.1998); *In re BankAmerica Corp. Sec. Litig.,* 1999 WL 1211839, *7 (E.D.Mo.1999). Other courts have concluded that the group pleading presumption is no longer viable after the passage of the PSLRA. *See Coates I,* 26 F.Supp.2d at 915-16; *Allison v.. Brooktree Corp.,* 999 F.Supp. 1342, 1350 (S.D.Cal.1998); *Marra v. Tel-Save Holdings, Inc.,* 1999 WL 317103,*5 (E.D.Pa.1999).

In *Coates I,* the court reasoned that because the PSLRA requires plaintiffs to set forth facts raising a

strong inference that each defendant acted with the required state of mind, group pleading is inconsistent with this section of the statute as well as the PSLRA's policy of protecting defendants from unwarranted claims and strike suits. 26 F.Supp.2d at 916; 15 U.S.C. § 78u-4(b)(2). The court further stated that "[i]t is nonsensical to require that a plaintiff specifically allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made the statement or omission." *Id.* The court in *Allison* reached a similar conclusion for the same reasons, holding that group pleading was suspect because the "judicial presumption" of group pleading could not "be reconciled with the statutory mandate that plaintiffs must plead specific facts as to each act or omission by the defendant." 999 F.Supp. at 1350. Although other courts have reached a contrary result, the court respectfully disagrees with those decisions, and adopts the reasoning in *Coates I* and *Allison* that bars the use of group pleading techniques in PSLRA cases. Furthermore, Plaintiffs' prolific use of the terms "defendants" and "Paymentech and the Individual Defendants" does not sufficiently plead fraud with particularity as required by Rule 9(b) and applicable Fifth Circuit case law. *See Williams,* 112 F.3d at 177-78; *Tuchman,* 14 F.3d at 1068. For these additional reasons, Plaintiffs' Complaint must be dismissed.

C. *Scienter Requirement*

In addition to the above-discussed pleading requirements, Plaintiffs must also plead scienter in accordance with the requirements established in the PSLRA, which states that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). In a section 10(b) case, the "required state of mind" is scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst,* 425 U.S. at 913 n. 12; *Tuchman,* 14 F.3d at 1067.

***9** A review of Plaintiffs' Complaint shows that Plaintiffs have attempted to plead scienter through the following allegations: 1) that "Defendants" or particular Defendants acted knowingly should have known, or were reckless in not knowing that particular representations were false, or that material facts were concealed or omitted, or that Defendants "falsely" made particular statements; [FN10] 2) that Defendant Truetzel resigned for "personal reasons" on the last day of the class period; [FN11] 3) that Defendants misled investors because they were motivated to ensure that the First USA--Banc One Merger closed; [FN12] 4) that Defendants failed to follow generally accepted accounting principles ("GAAP") and, more specifically, failed to break out revennes in specific ways so as to report certain transactions and charges; [FN13] 5) that given the magnitude of the revisions made to Paymentech's financial results, Defendants knew or recklessly disregarded the inaccuracies in the financial results that were initially reported; [FN14] 6) that Defendants' positions within the company made them privy to information that would have told them false statements were being made; [FN15] 7) that Patsley held a significant amount of Paymentech stock during the class period, and also received significant stock options as part of her compensation package; [FN16] 8) that Defendants and other senior officers of Paymentech were motivated to see the Merger close in order to increase the amount and transferability of their holdings of Paymentech and First USA stock; [FN17] and 9) that Patsley and other unnamed Paymentech officers were motivated to ensure that the Merger took place because they would receive loan forgiveness for loans made to them by First USA for the purchase of stock in Paymentech's initial public offering ("IPO"). [FN18] Some of these allegations are pleaded according to the motive and opportunity theory, while others assert conscious behavior or recklessness. Defendants move to dismiss Plaintiffs' Complaint, arguing that none of these theories adequately alleges scienter, regardless of which pleading standard applies. The court will begin by examining Plaintiffs' "motive and opportunity" allegations.

FN10. *See, e.g.,* Complaint at ¶¶ 5, 8, 9, 37, 44, 45, 52, 73, 74, 83.

FN11. *Id.* at ¶¶ 7, 17, 61.

FN12. *Id.* at ¶¶ 25, 51(d)(ii) and (v), 77.

FN13. *Id.* at ¶¶ 36, 37, 40, 41 42, 43, 44, 51, 64, 65, 66.

FN14. *Id.* at ¶ 74.

FN15. *Id.* at ¶¶ 19, 73.

FN16. *Id.* at ¶¶ 75-76.

FN17. *Id.* at ¶ 77.

FN18. *Id.* at ¶ 78.

1. *Motive and Opportunity*

a. *Allegations Related to the Merger*

Several of Plaintiffs' scienter allegations center on the theory that Defendants were motivated to commit fraud because they wanted to ensure the completion of the First USA-Banc One Merger. Defendants make two salient points, both of which indicate that Plaintiffs' motive allegations related to the Merger do not adequately establish motive. First, Plaintiffs have pleaded throughout their Complaint facts which emphasize the negative effect the Merger would have on Paymentech's performance, specifically that once First USA was acquired by Banc One, Paymentech's customer base would deteriorate because the banks that comprise Paymentech's customer base would be hesitant to share confidential information with Banc One, a competitor. Secondly, Plaintiffs have pleaded no facts showing that the Merger's terms were in any way dependent on Paymentech's stock price, or that the Merger would not close unless the stock price remained at a certain level.

***10** The court agrees that Defendants would not logically be motivated to push for a merger that they allegedly knew would cause significant harm to Paymentech and its stock value. This is particularly true considering that, according to the Complaint, Patsley took a large portion of her compensation in stock options, and held a considerable amount of Paymentech stock. Moreover, the Complaint states no facts showing that Paymentech's stock price would have had any effect on the Merger whatsoever. Plaintiffs' allegations with respect to the Merger do not adequately plead scienter.

b. *Patsley's Compensation*

Plaintiffs further allege that Patsley was motivated to inflate falsely the price of Paymentech's stock because she owned a large number of shares and because she took a significant portion of her compensation in stock options. The Fifth Circuit has held that allegations regarding executive compensation, without more, do not sufficiently plead a motive to commit securities fraud. *See Melder,* 27 F.3d at 1103; *Tuchman,* 14 F.3d at 1068-69; *accord Acito v. Imcera Group. Inc.,* 47 F.3d 47, 54 (2d Cir.1995). The other inference of fraudulent intent that could be drawn from these facts would relate to allegations of insider trading. Plaintiffs have pleaded no facts regarding Patsley's trading activity during the class period. Therefore, the facts pleaded concerning Patsley's compensation do not raise an inference that she acted with fraudulent intent.

2. *Conscious Misbehavior or Recklessness*

a. *Boilerplate Assertions*

Throughout the Complaint, Plaintiffs state in a conclusory fashion that Defendants "knew," "should have known," "were reckless" in not knowing, and "falsely" stated particular facts. [FN19] This type of conclusory recitation "fails to provide the specific facts upon which an inference of conscious behavior may be based." *Melder,* 27 F.3d at 1102. Here, Plaintiffs have pleaded no facts indicating that at the time the allegedly false statements were made, Defendants had actual knowledge of contradictory facts, and thus their Complaint does not state a claim for securities fraud. *See Tuchman,* 14 F.3d at 1069; *Coates I,* 26 F.Supp.2d at 920. Similarly, rote and conclusory allegations of recklessness do not support an inference of intent to defraud. *Melder,* 27 F.3d at 1103-04; *Coates II,* 55 F.Supp.2d at 641. Plaintiffs have not adequately pleaded scienter through these allegations.

FN19. *See* Footnote 9.

b. *Failure to Follow GAAP*

Plaintiffs also attempt to plead scienter through their assertions that Defendants failed to follow generally accepted accounting principles in several Form 10-Q's and one press release (the "July 23 rd Press Release"). The term "generally accepted accounting principles" encompasses a wide range of acceptable procedures. *Lovelace,* 78 F.3d at 1021; *Godchaux v. Conveying Techniques, Inc.,* 846 F.2d 306, 315 (5 th Cir.1988). Accordingly, as a general rule, failure to follow GAAP, without more, does

not adequately plead scienter. *Id.* at 1020; *Melder,* 27 F.3d at 1103; *Comshare,* 183 F.3d at 553. To establish scienter, "the party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information." *Lovelace,* 78 F.3d at 1020. Plaintiffs contend that the following facts raise a strong inference of fraud with respect to the alleged GAAP violations: that Truetzel and Patsley have professional backgrounds in accounting, [FN20] that due to their positions at Paymentech, they had "unfettered access" to Paymentech's internal financial information, that Paymentech had previously disclosed one-time transactions although it did not do so in financial statements issued during the class period, and that the magnitude of the revisions made to Paymentech's financial results establishes that Defendants knowingly concealed the GAAP violations.

FN20. The Complaint alleges that Patsley is a CPA who worked for a large public accounting firm before joining First USA, and that Truetzel was Paymentech's Chief Financial Officer. Complaint at ¶¶ 7, 16, 17.

***11** Allegations that a party knew or should have known that false representations were being made merely by virtue of his position within a company are, as a matter of law, insufficient to plead scienter. *Melder,* 27 F.3d at 1103. "Claims of securities fraud cannot rest on speculation and conclusory allegations." *Comshare,* 183 F.3d at 553; *San Leandro Emergency Med. Plan v. Philip Morris Cos.,* 75 F.3d 801, 813 (2d Cir.1996). This rule would similarly apply to Plaintiffs' contention that Patsley and Truetzel's accounting and finance training raises an inference that they knowingly misstated Paymentech's financial results.

Furthermore, that one-time transactions had been reported differently in prior periods and the alleged "magnitude" of the GAAP errors do not raise a "strong inference" that Defendants knowingly or recklessly misled the investing public. It is a common occurrence for public companies to revise their financial results. *Goldberg v. Household Bank, F.S.B.,* 890 F.2d 965, 967 (7 th Cir.1989). In this case, Paymentech's revisions did not reveal *less* earnings than previously reported, but instead broke its earnings out in more detail than it had before. The fact remains that even after the revisions, the initial statements made by Defendants were accurate with respect to the amount of Paymentech's earnings during the class period. Furthermore, Paymentech's statements with respect to its revenue growth continued to be accurate, albeit Paymentech was growing at a rate slower than that initially reported. While management's initial decision not to segregate one-time transactions and other events that contributed to Paymentech's earnings may be considered mismanagement or poor judgment, an inference of fraudulent intent is not raised thereby. Allegations that statements made in one report should have been revealed earlier do not indicate conscious misbehavior or recklessness. *Comshare,* 183 F.3d at 553-54; *Stevelman v. Alias Research, Inc.,* 174 F.3d 79, 84 (2d Cir.1999). Overall, Plaintiffs' allegations of GAAP violations do not sufficiently plead scienter by Defendants.

c. *Truetzel's Resignation*

Plaintiffs cannot adequately raise an inference of scienter by relying on the fact that Truetzel resigned at the end of the class period, when Paymentech's revised financial results were announced. With respect to Truetzel's resignation, the Complaint states that Truetzel resigned for personal reasons and nothing more. While it is clear that Plaintiffs wish to imply that Truetzel's departure was related to his alleged accounting malfeasance, they have pleaded no facts whatsoever to support this inference. These allegations simply do not support any inference of scienter.

D. *Section 10(b) Claim for Guiding Analysts*

Defendants have also moved to dismiss Plaintiffs' section 10(b) claim for guiding analysts. Corporate defendants may be held liable under section 10(b) for providing false or misleading information to securities analysts. *Robertson,* 32 F.Supp.2d at 450; *Cooper v.. Pickett,* 137 F.3d 616, 624 (9 th Cir.1997); *Warshaw v. Xoma Corp.,* 74 F.3d 955, 959 (9 th Cir.1996). In this case, the vast majority of Plaintiffs allegations that Defendants improperly inflated Paymentech's stock price by guiding and influencing securities analysts consists of boilerplate contentions that these unnamed analysts "relied in substantial part on information provided by [Paymentech]," [FN21] that unidentified Paymentech executives had a practice of communicating regularly with analysts and "to

provide detailed 'guidance' to these analysts," [FN22] and that the "investment community and, in turn, investors relied and acted upon" the information disseminated through the analysts. [FN23] These conclusory allegations do not state a claim for guiding analysts as a matter of law. *Suna v. Bailey Corp.,* 107 F.3d 64, 73 (1 st Cir.1997); *Raab v. General Physics Corp.,* 4 F.3d 286, 288 (4 th Cir.1993); *Time Warner,* 9 F.3d at 264.

FN21. Complaint at ¶ 81.

FN22. *Id.* at ¶ 82, 83.

FN23. *Id.* at ¶ 84.

***12** The only specific set of facts on which this claim is based concerns an analyst conference hosted by Paymentech in May 1997. [FN24] Plaintiffs' allegations regarding the May 1997 analyst conference are that analysts were given a report and shown a slide presentation prepared by Paymentech that highlighted Paymentech's plans for a target of 20-25% ongoing net revenue growth, a review of the first and second quarter financial results, and other unspecified "financial information." [FN25]

FN24. *Id.* at ¶ 46.

FN25. *Id.*

Defendants contend that the facts pleaded in support of this claim fail to state a claim for guiding analysts. This claim is subject to Rule 9(b) pleading requirements in that Plaintiffs must specify the alleged fraudulent statements, identify the speaker, state where and when the statements were made, and explain why the statements were fraudulent. *Suna,* 107 F.3d at 73. Here, Plaintiffs have not sufficiently identified the speaker by stating who gave the slide presentation. The only specific statement identified by Plaintiffs with respect to the May 1997 analyst conference was that Paymentech had plans for a target of 20-25% revenue growth. For two reasons, Plaintiffs have not pleaded facts showing why this statement was false. First, Plaintiffs state a few pages later in the Complaint that Paymentech actually experienced 24% revenue growth for the third quarter 1997. [FN26] Secondly, the statement alleged in Plaintiffs' Complaint reveals Paymentech's *plans* for a certain rate of revenue growth, rather than a representation of what its revenue growth actually would be. Plaintiffs have not pleaded facts showing that Paymentech untruthfully told those present at the May 1997 analyst conference what its plans were. Moreover, Plaintiffs' use of the word "target" reflects their understanding that the projected revenue growth announced at the analyst conference was a goal set by the company, not a concrete representation of actual revenues. For these reasons, Plaintiffs have failed to state a claim for guiding analysts.

FN26. *Id.* at ¶ 51(c).

E. *Section 20(a) Claim*

Plaintiffs' final claim is a claim for control person liability arising under section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). A claim for control person liability cannot be maintained unless an underlying violation by the controlled person is shown. Here, Plaintiffs have failed to adequately plead a violation by Paymentech, the controlled person. For this reason, their section 20(a) claim must also be dismissed. *Coates II,* 55 F.Supp.2d at 645; *Coates I,* 26 F.Supp.2d at 923.

IV. *Conclusion*

The decision to allow amendment of the pleadings is within the sound discretion of the district court. *Norman v. Apache Corp.,* 19 F.3d 1017, 1021 (5 th Cir.1994). In determining whether to allow an amendment of the pleadings, the court considers the following: undue delay in the proceedings, undue prejudice to the opposing parties, timeliness of the amendment, and futility of the amendment. *See Foman v. Davis,* 371 U.S. 178, 182 (1962); *Chitimacha Tribe of Louisiana v. Harry L. Laws Co., Inc.,* 690 F.2d 1157, 1163 (5 th Cir.1982).

***13** Plaintiffs have now had three opportunities to plead this lawsuit. Three bites at the apple is more than adequate opportunity to plead an action, if one exists, under the applicable law. The court believes that permitting a fourth pleading attempt would be an inefficient use of the parties' and the court's resources, would cause unnecessary and undue delay, and would be futile. For the reasons stated herein, Defendants' Motion to Dismiss Plaintiffs' Second Amended Class Action Complaint is granted, and Plaintiffs' claims are dismissed with prejudice. Judgment will be entered by separate

document.

END OF DOCUMENT

United States District Court, N.D. Texas, Dallas Division.

William F. CALLIOTT, et al., individually and on behalf of all persons
similarly situated, Plaintiffs,
v.
HFS, INC., et al., Defendants.

No. Civ.A. 3:97CV0924I.

March 31, 2000.

MEMORANDUM OPINION AND ORDER

LINDSAY, J.

*1 Before the court is HFS Defendants' Motion to Dismiss, filed November 10, 1997. Defendants HFS, Incorporated ("HFS or Defendant"), John D. Snodgrass ("Snodgrass"), Robert W. Pittman ("Pittman") and Stephen P. Holmes ("Holmes") [FN1] move to dismiss Plaintiffs' Amended Class Action Complaint ("Complaint"), filed September 19, 1997, pursuant to Fed.R.Civ.P. 9(b) and 12(b)(6) and sections 21D(b)(3)(A) and 21E(c)(1)(B) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78u-4(b)(3)(A) and 15 U.S.C. § 78u-5(c)(1)(B), as amended by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Plaintiffs oppose the motion, arguing that they have adequately pled each of their claims to survive dismissal. After careful consideration of the motion, response, reply, the supplemental filings submitted by both parties, and the applicable law, the court, for the reasons that follow, grants Defendant's Motion to Dismiss.

FN1. Plaintiffs' claims against Defendants Snodgrass, Pittman and Holmes, as well as the other individual defendants named in Plaintiffs' Complaint, have been dismissed pursuant to a Stipulation of Settlement, filed January 19, 1999 and Final Judgment and Order of Dismissal, filed August 12, 1999 The only remaining Defendant in this lawsuit is HFS, Inc.

I. *Factual and Procedural Background*

Defendant HFS is a Delaware corporation with its principal place of business in Parsippany, New Jersey. Plaintiffs are a class of persons who purchased or otherwise acquired common stock of Amre, Inc. ("Amre") during the period between February 28, 1996 and January 16, 1997. During the class period, Snodgrass, Pittman and Holmes were officers and directors of HFS, or its wholly owned subsidiary Century 21 Real Estate Corporation ("Century 21 Real Estate"). In particular, Snodgrass was President, Chief Operating Officer and a director of HFS, as well as chairman of Century 21 Real Estate's Board of Directors; Pittman was a director of HFS, and managing partner and Chief Executive Officer of Century 21 Real Estate; and, Holmes was the Executive Vice President and Chief Financial Officer of HFS. In addition, all three served as directors of Amre, with Snodgrass serving as chairman of the board.

Plaintiffs allege that prior to filing bankruptcy in January 1997, Amre marketed and sold home improvement services and remodeling products, such as vinyl siding, windows, patios, and swimming pools. On October 17, 1995, Amre entered into a license agreement with Century 21 Real Estate and TM Acquisition Corporation ("TMAC"), wholly owned subsidiaries of HFS. Under that agreement, Amre was granted an exclusive 20-year license to market its products and services under the name "Century 21 Home Improvements" ("Century 21"). Plaintiffs allege that the agreement also provided for HFS to designate certain of its officers, namely Snodgrass, Pittman and Holmes, to serve on Amre's Board of Directors. Plaintiffs assert that HFS, through these representatives, participated in the day-to-day operations of Amre. Plaintiffs allege that in addition to the license agreement, Amre entered into two separate agreements with HFS - a Preferred Stock Agreement and Credit Agreement. Under those agreements, HFS agreed to extend Amre a line of revolving credit in the amount of $4 million, and to purchase 300,000 shares of Amre's Senior Convertible Preferred Stock.

*2 Prior to its license agreement with Century 21 Real Estate and TMAC, Amre operated under a license agreement with Sears Roebuck & Co. ("Sears") and marketed its products and services

under the Sears name for thirteen years until its license expired on December 31, 1995. Amre's operation under the Century 21 name, however, was not successful. On January 17, 1996, just over a year after it began operating under the Century 21 name, Amre declared bankruptcy. Plaintiffs allege that during the class period, representatives of Amre and Defendant made false or misleading statements regarding Amre's business dealings with HFS, Amre's transition to the Century 21 name, consumer response to the Century 21 name, and HFS's support of Amre. These alleged misrepresentations, according to Plaintiffs, caused an artificial inflation in the price of Amre's stock. Plaintiffs filed this lawsuit on April 23, 1997, alleging claims against Defendant and Amre representatives under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, and section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). Plaintiffs also allege a claim for negligent misrepresentation under state law. On September 19, 1997, Plaintiffs filed their Amended Class Action Complaint ("Plaintiffs' Complaint"), and Defendants now move to dismiss Plaintiffs' Complaint for failure to state a claim under Fed.R.Civ.P. 12(b)(6), and for failure to plead fraud with particularity pursuant to Fed.R.Civ.P. 9(b) and Section 21D(b) of the Exchange Act.

II. *Applicable Legal Standards*

A. *Standard for Motion to Dismiss*

A motion to dismiss for failure to state a claim under Fed.R.Civ.P. 12(b)(6) "is viewed with disfavor and is rarely granted." *Lowrey v. Texas A & M University System,* 117 F.3d 242, 247 (5 th Cir.1997). The court cannot dismiss Plaintiffs' claims under Rule 12(b)(6) unless it appears beyond doubt that they can prove no set of facts entitling them to relief. *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957); *Coates v. Heartland Wireless Communications, Inc.,* 26 F.Supp.2d 910, 913-14 (N.D.Tex.1998) ("*Coates I*"). In reviewing a Rule 12(b)(6) motion, the court must accept all well pleaded facts in the complaint as true and view them in the light most favorable to the plaintiff. *Baker v. Putnal,* 75 F.3d 190, 196 (5 th Cir.1996). The court, however, will not accept conclusory allegations in the complaint as true. *Kaiser Aluminum & Chem. Sales, Inc. v. Avondale Shipyards, Inc.,* 677 F.2d 1045, 1050 (5 th Cir.1982), *cert. denied,* 459 U.S. 1105 (1983); *Robertson v. Strassner,* 32 F.Supp.2d 443, 445 (S.D.Tex.1998); *Zuckerman v. Foxmeyer Health Corp.,* 4 F.Supp.2d 618, 621 (N.D.Tex.1998).

B. *Standard for Pleading Securities Fraud*

To survive dismissal, Plaintiffs must have alleged facts that show they are entitled to relief on their substantive cause of action. Plaintiffs assert a claim pursuant to Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, as amended by the PSLRA. Section 10(b) of the Exchange Act makes it unlawful for a person to:

***3** use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). In relevant part, Rule 10b-5 makes it unlawful for any person, directly or indirectly, to:

make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. To state a claim for securities fraud in violation of section 10(b) and Rule 10b-5, a plaintiff must allege (1) a misrepresentation or omission; (2) of a material fact; (3) made with the intent to defraud; (4) on which the plaintiff relied; and (5) which proximately caused the plaintiff's injury. *Williams v. WMX Technologies, Inc.,* 112 F.3d 175, 177 (5 th Cir.1997); *Tuchman v. DSC Communications Corp.,* 14 F.3d 1061, 1067 (5 th Cir.1994); *Cyrak v. Lemon,* 919 F.2d 320, 325 (5 th Cir.1990). In cases such as this, where a plaintiff alleges a "fraud on the market" theory, it is not necessary for the plaintiff to prove individual reliance on the false or misleading statement. *In re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1112-14 (9 th Cir.1989), *cert. denied,* 496 U.S. 943 (1990); *Coates I,* 26 F.Supp.2d at 914 n.1; *Zuckerman,* 4 F.Supp.2d at 621. Instead, a plaintiff may show that he indirectly relied on the statements by relying on the integrity of the market price of the stock. *Id.*

C. *Rule 9(b) Requirements*

Because section 10(b) claims are fraud claims, the plaintiff must also satisfy the pleading requirements imposed by Fed.R.Civ.P. 9(b). *Melder v. Morris,* 27 F.3d 1097, 1100 (5 th Cir.1994); *Tuchman,* 14 F.3d at 1067. Rule 9(b) requires certain minimum allegations in a securities fraud case, namely, the specific time, place, and contents of the false representations, along with the identity of the person making the false representation and what the person obtained thereby. *Melder.* 27 F.3d at 1100; *Shushany v. Allwaste, Inc.,* 992 F.2d 517, 521 (5 th Cir.1993). This application of the heightened pleading standard of Rule 9(b) provides defendants with fair notice of the plaintiffs' claims, protects them from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims and then attempting to discover unknown wrongs. *Melder,* 27 F.3d at 1100; *Tuchman,* 14 F.3d at 1067.

D. *Particularity Requirements of the PSLRA*

The PSLRA has further reinforced this particularity requirement with respect to pleading securities fraud claims. *Coates I,* 26 F.Supp.2d at 914. The PSLRA provides that

> ***4** the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). A plaintiff alleging securities fraud must, therefore, not only allege the time, place, identity of the speaker, and content of the alleged misrepresentation, but also explain why the challenged statement or omission is false or misleading. *Williams,* 112 F.3d at 179. To satisfy Rule 9(b) and the PSLRA, a plaintiff must plead facts and avoid reliance on conclusory allegations. *Tuchman,* 14 F.3d at 1067; *Coates I,* 26 F.Supp.2d at 915.

E. *Scienter Requirement*

In addition to the aforementioned pleading requirements, plaintiffs asserting securities fraud claims must allege facts demonstrating scienter. *Lovelace v. Software Spectrum, Inc.,* 78 F.3d 1015, 1018 (5 th Cir.1996); *Tuchman,* 14 F.3d at 1068; *Zuckerman,* 4 F.Supp.2d at 622. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976); *Lovelace,* 78 F.3d at 1018. To adequately plead scienter, the plaintiff must set forth specific facts to support an inference of fraud. *Lovelace,* 78 F.3d at 1018; *Tuchman,* 14 F.3d at 1068. The PSLRA requires that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). When a complaint fails to plead scienter in conformity with the PSLRA, dismissal is required. 15 U.S.C. § 78u-4(b)(3)(A); *Coates v. Hearland Wireless Communications. Inc.,* 55 F.Supp.2d 628, 634 (N.D.Tex.1999) (*"Coates II"*). A plaintiff may plead scienter by alleging facts to show that a defendant had both motive and opportunity to commit fraud, *Branca v. Paymentech, Inc.,* No. CIV.A.3:97-CV- 2507-L, 2000 WL 145083, at *5 (N.D.Tex. Feb. 8, 2000), or by pleading facts which identify circumstances indicating Defendants' conscious or reckless behavior, so long as the totality of the allegations raises a strong inference of fraudulent intent. *Zuckerman,* 4 F.Supp.2d at 623; *Robertson,* 32 F.Supp.2d at 447.

III. *Analysis*

Defendant contends that Plaintiffs' Complaint is deficient because it lacks the factual specificity required under Rule 9(b) and the PSLRA, and additionally because Plaintiffs have not adequately pleaded facts raising a strong inference of scienter. The court addresses each of these contentions below separately.

A. *Particularity Requirements of Rule 9(b) and the PSLRA*

Plaintiffs allege that during the class period, Defendant and Amre representatives made false and misleading statements concerning consumer response to the Century 21 name, Amre's expected financial results, Amre's bank of sales leads, and HFS's support of Amre. Plaintiffs also allege that Amre representatives failed to disclose material negative information such as lack of proper training and supervision in Amre's telemarketing department, the

telemarketing department's massive turnover rate, lower closing rates, lack of interest by Century 21 real estate agents in referring customers to Amre, increased marketing expenses, lack of profitability, and Amre's need for outside financing. Defendant contends that the statements which Plaintiffs allege as false or misleading are nothing more than general expressions of optimism which are not actionable under the federal securities laws. Defendant further contends that because Amre's optimistic statements were accompanied by cautionary warnings, and alerted the market that the Century 21 transition was risky and uncertain, there can be no liability under § 10(b) based on these statements. Defendant also contends that Plaintiff's Complaint contanis only conclusory allegations of securities fraud, and, therefore, fails to satisfy the stringent pleading requirements of Rule 9(b) and the PSLRA.

***5** At a minimum, Rule 9(b) requires allegations of the particulars of time, place, and contents of the false representations, as well as the identity of the person making the misrepresentation and what he obtained thereby. *Shushany,* 992 F.2d at 521. Plaintiffs argue that they have met this pleading burden by alleging with particularity those statements which they contend were false and misleading. While the court agrees with Plaintiffs that they have alleged by time, place, content and speaker nurnerous statements allegedly made by representatives of Defendant and Amre in various press releases, Securities and Exchange Commission ("SEC") filings, and in other contexts, [FN2] the court finds that the majority of the statements, which Plaintiffs contend were false or misleading, has not been pled with sufficient particularity to satisfy the requirements of Rule 9(b). With respect to the statements identified by Plaintiffs in ¶¶ 51, 56, 58, 61, 63, 65, 66, 67, 68, 70, 87, 89 and 90 of Plaintiffs' Complaint, Plaintiffs have either failed to identify the speaker of the alleged fraudulent statement, failed to specifically identify the false or misleading statement, or attempt to use group pleading to allege fraud. [FN3] Because Plaintiffs have failed to identify the person making the alleged misrepresentation in each of the aforementioned paragraphs, the court finds that Plaintiffs have failed to satisfy the heightened pleading standard required by Rule 9(b). Moreover, Plaintiffs have failed to allege facts which indicate that the statements identified in those paragraphs were false or misleading when made, or that they were made with fraudulent intent. The court, therefore, concludes that with respect to statements contained in ¶¶ 51, 56, 58, 61, 63, 65, 66, 67, 68, 70, 87, 89 and 90 of Plaintiffs' Complaint, Plaintiffs have not sufficiently alleged facts to support a claim under Section 10(b) because they have not satisfied the strict pleading requirements of Rule 9(b) or the PSLRA.

FN2. Complaint at ¶¶ 48, 50, 60, 73, 76, 77, 78, 79, 80, 82, 83, and 84

FN3. Under the group pleading doctrine, a plaintiff may rely on a presumption that statements in prospectuses, press releases, and other company generated documents are the collective work of those individuals directly involved in the company's daily management. *Branca,* 2000 WL 145083, at *7. In *Branca,* the court declined to recognize group pleading as a viable means to plead fraud under the PSLRA. *See Branca,* 2000 WL 145083, at *8 (group pleading is inconsistent with the PSLRA's requirement that plaintiffs plead specific facts as to each act or omission by the defendant).

With respect to the statements identified by Plaintiffs in ¶¶ 48, 50, 60, 73, 76, 77, 78, 79, 80, 82, 83, and 84 of Plaintiffs' Complaint, the court finds that Plaintiffs have satisfied the pleading requirements of Rule 9(b) by alleging the time, place, content and speaker of the statements which they allege were false or misleading. These alleged misrepresentations concern consumer response to the Century 21 name, Amre's expected financial results, Amre's bank of sales leads, and HFS's support of Amre. The court addresses each in turn.

1. *Consumer Response to the Century 21 Name*

Plaintiffs allege that during the class period, Amre representatives made statements that management was "encouraged" and "pleased" by customer receptivity to the Century 21 Home Improvements name ("the Century 21 name" or "name"), that Amre had proved that the Century 21 name worked, that Amre was able to market its products under the name, that Amre's bank of sales leads had increased under the name and that Amre's bank of sales leads was at higher levels than before transition to the Century 21 name. [FN4] Plaintiffs allege that these statements were false or misleading because at the time the statements were made, representatives of both Defendant and Amre knew of adverse facts

tending to undermine the accuracy of the statements, including knowledge that consumer response to the Century 21 name was poor. Defendant contends that any statements by Amre's representatives that they were "encouraged" or "pleased" by customer receptivity are not actionable under the federal securities laws because such statements were no more than general expressions of optimism. Plaintiffs respond that general expressions of optimism and statements of opinion or belief are actionable, if such statements are made with no reasonable basis. In support of their position, Plaintiffs cite *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9 th Cir.1989), *cert. denied,* 496 U.S. 943 (1990). The court first observes that, unlike this case, *Apple Computer* was reviewed under a summary judgment standard. As a result, the plaintiffs were required to present evidence establishing a genuine issue of material fact as to each element of their claim. *Id.* at 1112-13. The court in that case concluded that genuine issues of material fact existed regarding certain optimistic statements made by defendants because plaintiffs presented evidence that at the time the statements were made, defendants knew of adverse facts tending to undermine defendants' expressions of optimism. *Id.* at 1115. Here, Plaintiffs allege no facts to support its conclusory assertion that Amre's management did not have a reasonable basis for being "encouraged" or "pleased" by consumer response to the Century 21 name. While Plaintiffs argue that consumer response to the Century 21 name was poor, they allege no facts to support this conclusion. Although Plaintiffs assert that Amre was experiencing problems with its telemarketing department, and a lack of interest in referrals to Amre from Century 21 real estate agents, these facts do not support Plaintiffs' conclusion that consumer response to the Century 21 name was poor. Arguably, that Amre experienced an increase in revenues during the class period, as well as an increase in the number of leads in Amre's lead bank, undermines Plaintiffs' argument that there was no basis for statements by Amre representatives that management was encouraged or pleased by consumer response to the Century 21 name. Plaintiffs have wholly failed to allege facts which indicate that Amre representatives knew or should have known of adverse information tending to undermine statements that they were encouraged or pleased by customer response to the Century 21 name.

FN4. Complaint at ¶¶ 48, 50, 56, 60, 61, 63, 76, and 78.

***6** To state a claim for securities fraud, Plaintiffs must allege, *inter alia,* a misstatement or omission of a material fact. *Williams,* 112 F.3d at 177. A fact is material in the context of a § 10(b) claim if there is a substantial likelihood that a reasonable investor would consider it significant in making the decision to invest, such that it alters the total mix of information available about the proposed investment. *Basic Inc. v. Levinson,* 485 U.S. 224, 231-232 (1988); *Rubinstein v. Collins,* 20 F.3d 160, 168 (5 th Cir.1994). The court agrees with Defendant that the statements made by Amre representatives that management was encouraged and pleased by customer receptivity to the Century 21 name were merely expressions of optimism, and too vague to be material. *See Greebel v. FTP Software, Inc.,* 194 F.3d 185, 207 (1 st Cir.1999); *In re Mobile Telecommunication Technologies Corp Sec. Litig.,* 915 F.Supp. 828, 834 (S.D.Miss.1995). Securities "[a]nalysts ... rely on facts in determining the value of a security, not mere expressions of optimism from company spokesmen." *Raab v. General Physics Corp.,* 4 F.3d 286, 290 (4 th Cir.1993). Plaintiffs allege that statements by Amre representatives that they had proved to themselves that Century 21 name generated consumer interest in their products and, therefore, sales leads, and that they had proved that the Century 21 name worked were false and misleading because of poor consumer response. The court finds that these statements are more akin to commercial puffery than representations of material facts. *See In re Mobile Telecommunication Technologies Corp. Sec. Litig.,* 915 F.Supp. at 834; *San Leandro Emergency Med. Group Profu Sharing Plan v. Philip Morris Cos.,* 75 F.3d 801, 811 (2d Cir.1996). The court finds that Plaintiffs have failed to satisfy the particularity requirements of the PSLRA because they have not alleged sufficient non-conclusory facts which indicate that the statements by Amre representatives were false or misleading.

2. *Amre's Expected Financial Results*

Plaintiffs allege that statements accompanying Amre's quarterly reports, which characterized Amre's disappointing financial results as "expected" and "anticipated," were false or misleading because Amre had not expected a decline in revenues due to

poor consumer response. Plaintiffs contend that representatives of Defendant and Amre knew or should have known the statements were false or misleading because Amre was experiencing undisclosed problems concerning its marketing activities. Specifically, Plaintiffs allege that Amre's telemarketing department lacked proper training and supervision, that the telemarketing department experienced a massive turnover rate, that the constant hiring of new employees resulted in a poorly trained and inexperienced telemarketing staff, lower closing rates, and higher costs, and that Amre's sales force of field agents was lax in keeping appointments with potential customers. [FN5] Defendant responds that investors were made aware of the problems concerning Amre's telemarketing department through Amre's SEC filings, and that any statements concerning Amre's expected results are shielded under the "bespeaks caution" doctrine. [FN6] The court finds that the "bespeaks caution" doctrine is not applicable to the statements identified by Plaintiffs concerning Amre's expected financial results because the statements are not predictions, but statements of existing fact. [FN7] *Griffin v. GK Intelligent Systems, Inc.*, No. Civ.A. H-98-3847, 1999 WL 1425407, at *4 (S.D.Tex. Oct. 26, 1999). As a result, the "bespeaks caution" doctrine is of no assistance to Defendant as to those statements.

FN5. Complaint at ¶¶ 52-54.

FN6. Under the "bespeaks caution" doctrine, if a defendant adds a cautionary statement to a predictive statement, then the statement may not be actionable as a matter of law. *Zuckerman,* 4 F.Supp.2d at 624 (*citing Rubinstein v. Collins,* 20 F.3d 160, 166 (5 th Cir.1994)). If a statement, however, is false by failure to fully disclose information, a duty arises to speak the full truth when a defendant undertakes the duty to say anything. *Zuckerman,* 4 F.Supp.2d at 625.

FN7. Complaint at ¶¶ 50, 60 and 76.

***7** While Plaintiffs do not dispute the accuracy of Amre's reported quarterly financial results, they argue that Amre's statements concerning the results were misleading because Amre had not expected consumers to respond poorly to the Century 21 name. Therefore, according to Plaintiffs, the disappointing financial results could not have been expected by Amre representatives. Plaintiffs, however, allege no facts to show that the statements concerning Amre's expected or anticipated financial results were false or misleading, or that representatives of Defendant or Amre had knowledge of adverse information tending to undermine the accuracy of those statements. Plaintiffs contend that statements about Amre's "expected" transitional revenue declines, when evaluated in context, give rise to section 10(b) liability because they created the impression that revenue declines were the normal downturns one would expect when adopting a new brand name, and did not reveal that poor consumer response was a significant reason for the declines. Plaintiffs attempt to plead fraud based on the premise that Defendants knew of, but intentionally concealed, material information about consumer response to the Century 21 name. This premise, however, is weakened by Plaintiff's failure to plead specific facts which indicate that consumers responded poorly to the Century 21 name. In addition, Plaintiffs have failed to allege facts which show conscious misbehavior by representatives of Defendant or Amre. As a result, the court finds that Plaintiffs cannot state a claim for securities fraud based on the statements of Amre representatives regarding their "expected" or "anticipated" financial results.

3. *Amre's Bank Leads*

Plaintiffs contend that certain statements made by Amre's management concerning the number of sales leads generated under the Century 21 name were false or misleading because leads after Amre switched to the Century 21 name were a lower quality than the pre-switch leads. [FN8] Plaintiffs, however, allege no facts to show that the statements concerning the sales leads were false or misleading when made. Plaintiffs contend that Defendants were required to disclose all material facts about the leads, including their quality. Plaintiffs, however, cite no authority to support their position. The court has scrutinized the allegations concerning Amre's bank leads in light of the pleading requirements of § 10(b) and finds that Plaintiffs have failed to allege facts sufficient to state a claim under § 10(b) of the Exchange Act based on the statements concerning Amre's bank leads.

FN8. *See* Plaintiffs' Complaint at ¶¶ 60, 76, 79, and 87.

4. *HFS's Support of Amre*

Plaintiffs contend during a telephone conference with analysts held on October 31, 1996, Snodgrass made false and misleading statements concerning the HFS's continued support of Amre. During that conversation, Plaintiffs allege that Snodgrass made statements that HFS had a strong commitment to Amre, that HFS was committed to the success of Amre, that it was in the common interest of HFS and Amre that Amre be successful, that HFS had consistently supported Amre financially and he saw no change in that strategy. Plaintiffs contend that these statement were false or misleading because the relationship with Amre was not strong, that HFS was not committed to helping Amre find a solution to its capital needs, that HFS never intended to contribute a significant amount of cash to or buy a big stake in Amre, and that HFS was unwilling to provide Amre with the additional capital that the company needed to complete its transition to the Century 21 name. Plaintiff's, however, allege no facts to support these conclusory allegations. Plaintiffs plead no facts which indicate that these statements were false, or that Snodgrass had knowledge at the time he made the statements of adverse information tending to undermine the accuracy of the statements. Plaintiffs plead no facts which indicate that HFS intended to terminate its relationship with Amre, or that HFS had no intention of assisting Amre find solutions to its capital needs. Because Plaintiffs have failed to allege facts which indicate that statements concerning HFS's support of Amre were false or misleading, Plaintiffs have failed to comply with the PSLRA, and, therefore, cannot state a claim under § 10(b) of the Exchange Act based on these statements.

B. *Scienter Requirement*

***8** Plaintiffs contend that Defendant acted with scienter in (1) failing to disclose adverse facts about consumer response to the Century 21 name, and (2) expressing its commitment to Amre. Plaintiffs, however, fail to allege with particularity facts to support a strong inference that Defendants acted recklessly or with fraudulent intent. The PSLRA requires a complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Plaintiffs have wholly failed to adduce the kind of circumstantial evidence that would indicate conscious fraudulent behavior or recklessness.

1. *Motive and Opportunity*

Plaintiffs contend that Amre was motivated to misrepresent consumer response to the Century 21 name because it wanted to sell approximately 1.1 million shares of its common stock for its own account. Plaintiffs further allege that Amre's officers and directors were motivated to engage in misrepresenting consumer reaction to the Century 21 name to preserve their own positions and perquisites as officers or directors of Amre, and to inflate the price of Amre common stock so that they could profit from their own sale of the stock during the class period. [FN9] Plaintiffs, however, allege no facts which indicate that the HFS Defendants purchased or sold stock during the class period. While Plaintiffs contend in their response to Defendant's motion to dismiss that HFS sold stock during the period, Plaintiffs' Complaint does not allege facts to show that HFS sold any stock during the class period. Plaintiffs' Complaint simply alleges that HFS's stock was "included in the Amre September offering," not that HFS's stock was actually sold. Plaintiffs also allege that HFS was motivated to engage in the alleged misconduct because it wanted to sell its Amre common stock at a high price, and wanted to ensure a merger with PHH Corporation. [FN10] The court, however, finds that Plaintiffs' general allegations of motive are insufficient to plead scienter for a § 10(b) claim.

FN9. Complaint at ¶¶ 114, 115.

FN10. Complaint at ¶ 126.

2. *Conscious Misbehavior or Recklessness*

Throughout the Complaint, Plaintiffs state in conclusory fashion that Defendants "knew," "should have known," "were reckless" in not knowing, and "falsely" stated particular facts. This type of conclusory recitation "fails to provide the specific facts upon which an inference of conscious behavior may be based." *Melder,* 27 F.3d at 1102. Here, Plaintiffs have pleaded no facts indicating that at the time the allegedly false statements were made, Defendants had actual knowledge of contradictory facts, and thus their Complaint does not state a claim for securities fraud. *See Tuchman,* 14 F.3d at

1069; *Coates I,* 26 F.Supp.2d at 920. Similarly, rote and conclusory allegations of recklessness do not support an inference of intent to defraud. *Melder,* 27 F.3d at 1103-04; *Coates II,* 55 F.Supp.2d at 641. Plaintiffs contend that HFS, Snodgrass, Pittman and Holmes acted with scienter in misrepresenting that HFS's relationship with Amre was strong and that there was no foreseeable change in HFS support for Amre. In their response to Defendant's motion to dismiss, Plaintiffs assert that after Amre declared bankruptcy, the financial press reported statements by Henry Silverman, HFS chairman and Chief Executive Officer, that he did not think the business was executed well, and that he did not think they could control their cost of doing business. *See* Plaintiffs' Brief in Opposition to Defendants' Motions to Dismiss, at p. 36. Plaintiffs further contend that Mr. Silverman stated that he never intended to contribute significant cash or buy a big stake in Amre. *Id.* The court, however, is unpersuaded. First, Plaintiffs have not alleged this in their Complaint and second, even if these statements were contained in Plaintiffs' Complaint, they would be an impermissible attempt to allege fraud by hindsight, that is, to seize upon disclosures in later reports and allege that they should have been made in earlier ones. *Coates II,* 55 F.Supp.2d at 635. Plaintiffs have not adequately pleaded scienter through these allegations.

IV. *Plaintiffs' Remaining Claims*

1. *Section 20(a) Claim*

***9** Plaintiffs' second claim alleges violations of section 20(a) of the Exchange Act. This section defines controlling person liability, providing that:

> [e]very person, who, directly or indirectly, controls any person liable under any provision of this chapter ... shall also be liable jointly and severally with and to the same extend as such controlled person....

15 U.S.C. § 78t(a). Where a primary violation by the "controlled person" has not been adequately pleaded, the court should also dismiss a section 20(a) claim. *Coates I,* 26 F.Supp.2d at 923. As Plaintiffs have failed to adequately plead a violation of Amre, the alleged controlled person, Plaintiffs' section 20(a) claim must also be dismissed. *Id.; Coates II,* 55 F.Supp.2d at 645.

2. *Negligent Misrepresentation Claim*

As the court has dismissed Plaintiffs' federal claims, the court now dismisses Plaintiffs' state law claim for negligent misrepresentation without prejudice. Pursuant to 28 U.S.C. § 1367(c)(3), the court is authorized to dismiss state law claims without prejudice when it has dismissed all claims over which it has original jurisdiction. Accordingly, the court in its discretion dismisses Plaintiffs' state law claims without prejudice.

V. *Conclusion*

In light of the court's ruling, the question arises whether Plaintiffs should be allowed to amend. The decision to allow amendment of pleadings is within the sound discretion of the court. *Norman v. Apache Corp.,* 19 F.3d 1017, 1021 (5 th Cir.1994). In determining whether to allow an amendment of the pleadings, the court considers the following: undue delay in the proceedings, undue prejudice to the opposing parties, timeliness of the amendment, and futility of the amendment. *See Foman v. Davis,* 371 U.S. 178, 182 (1962); *Chitimacha Tribe of Louisiana v. Harry L. Laws Co., Inc.,* 690 F.2d 1157, 1163 (5 th Cir.1982).

Plaintiffs have now had two opportunities to plead this lawsuit. Two bites at the apple is more than adequate opportunity to plead an action, if one exists, under the applicable law. The court believes that permitting a third pleading attempt would be an inefficient use of the parties' and the court's resources, would cause unnecessary and undue delay, and would be futile. For the reasons stated herein, the HFS Defendants' Motion to Dismiss Plaintiffs' amended class action complaint is granted. Plaintiffs' federal claims are hereby dismissed with prejudice, and Plaintiffs' state-law claims are dismissed without prejudice. Judgment will be entered by separate document.

END OF DOCUMENT

Only the Westlaw citation is currently available.

United States District Court, S.D. New York.

Edward B. MISHKIN, as SIPA Trustee for the Liquidation of the Business of Adler, Coleman Clearing Corp., Plaintiff,
v.
Roy AGELOFF, Robert F. Catoggio, Lowell Schatzer, Ronan Garber, Joseph Dibella, John Lembo, Mark A. Mancino, Joseph Scarfone, Chris Wolf, Randy M. Ashenfarb, Earl Rusnak, and Danny Garber, Defendants.

No. 97 Civ. 2690 LAP.

Sept. 23, 1998.

MEMORANDUM AND ORDER

PRESKA, J.

***1** By Memorandum and Order dated March 31, 1998, I withdrew the reference in this matter and two related proceedings. *See Mishkin v. Ageloff,* 220 B.R. 784 (S.D.N.Y.1998) (*"Mishkin I"*). Familiarity with that decision, and its discussion of the interlocking nature of this action with the two others, is assumed. Pending before me in this matter are motions to dismiss pursuant to Fed. R. Civ. Proc. 9(b) and 12(b)(6). Some defendants have also moved to strike certain statements in the Complaint pursuant to Fed. R. Civ. Proc. 12(f). For the reasons that follow, the motions are denied except as to defendant Ageloff's motion to dismiss the claims against him. That motion is granted. Finally, in light of this decision, the Trustee is hereby granted leave to file an amended complaint.

BACKGROUND

For purposes of the present motion, the following facts are presumed to be true. This action stems from the collapse of Hanover Sterling & Company, Ltd. ("Hanover"), which in turn caused the collapse of Adler, Coleman Clearing Corp. ("Adler") in February 1995. By Order dated February 27, 1995, and pursuant to 15 U.S.C. §§ 78eee(b)(3) & 78eee(b)(4), I appointed Edward B. Mishkin as the SIPA Trustee ("the Trustee") for Adler's liquidation.

In this action, the Trustee seeks to recover some $70,000,000 in damages based upon violations of: (1) section 10(b) of the Securities and Exchange Act of 1934 ("the Exchange Act") and rule 10b-5 promulgated thereunder by the SEC; (2) section 20(a) of the Exchange Act; and (2) New York's common law of fraud. There are twelve defendants, all of whom are former employees and officials of Hanover. Of these, eight have filed motions, in one form or another, to dismiss: Roy Ageloff ("Ageloff"), Ronan Garber, Danny Garber, John Lembo ("Lembo"), Chris Wolf ("Wolf"), Mark A. Mancino ("Mancino"), Joseph DiBella ("Dibella") and Robert F. Catoggio ("Catoggio"). [FN1]

FN1. Dibella filed a "me-too" motion to dismiss incorporating the arguments of the other defendants.

Hanover cleared trades through Adler. *See* Complaint ¶ 5. As an introducing firm, Hanover gathered information from its customers concerning their trades and relayed this information to Adler. *See id.* ¶¶ 5 & 30. Hanover had complete responsibility for the accuracy of the information entered into Adler's clearing system. *See id.* ¶ 5. As a clearing house, Adler did not promote stocks or act as an underwriter. *See id.* ¶ 31. Instead, Adler held Hanover's customers' cash and securities and sent account statements and trade confirmations to Hanover's customers. *See id.* ¶ 30. This process of clearing and settling trades is essentially the process of ensuring that the correct securities and cash are recorded in the proper accounts after a trade is complete. *See id.* ¶ 31. Hanover also maintained its own proprietary accounts and utilized Adler's services to clear trades in these accounts. *See id.* ¶ 31. Finally, and most important to the present matter, Adler guaranteed that Hanover's trades would clear, *i.e.,* if a customer did not pay for the securities, Adler guaranteed that it would cover the transaction. *See id.* ¶¶ 8 & 44.

***2** Generally speaking, Hanover's business consisted of acting as an underwriter for the initial public offerings of certain companies and thereafter acting as the primary market maker for these securities. *See id.* ¶ 32. The parties refer to these securities as the House Stocks, and the Complaint identifies them by name. *See id.* ¶ 2. Hanover owned substantial positions in the House Stocks and used the House Stocks to meet its capital

requirements. *See id.* ¶¶ 2 & 32. In addition, even for trades between two customers in the House Stocks, the trades were made through Hanover's proprietary accounts. *See id.* ¶ 31. Accordingly, and for all of these reasons, fluctuations in the value of the House Stocks affected Hanover's liquidity and net capital position.

As detailed in *Mishkin I,* a group of outsiders (defendants in the Gurian Proceeding) [FN2] identified Hanover as a "vulnerable target" and hatched a scheme to profit from this vulnerability. In brief, they caused downward pressure on the House Stocks and, in turn, sold them short. *See Mishkin I,* 220 B.R. at 787-88. Because Hanover's proprietary accounts consisted of substantial positions in the House Stocks, this downward pressure affected Hanover's net capital position. *See* Complaint ¶ 40. As a result of this activity, the defendants in this matter are alleged to have engaged in two distinct but related fraudulent schemes. Simply stated, the first scheme was designed to prop up the value of the House Stocks in response to the downward pressure exerted by the defendants in the Gurian Proceeding. Once it was clear that the first scheme would not succeed, the second scheme was designed to protect a group of Hanover's largest customers ("the Favored Customers") from Hanover's inevitable financial collapse.

FN2. Reference to the "Gurian Proceeding" is to an action brought by the Trustee against another group of defendants. This proceeding is discussed in greater detail in *Mishkin I.*

The success of both schemes depended upon the timing of Adler's clearing function. *See id.* ¶¶ 31 & 34-35. After Adler received information about a trade from Hanover, it would generally take five business days for the trade to settle. *See id.* For example, a buyer of stock would have her account debited immediately, but the buyer was not obligated to deliver cash to pay for the securities until five business days after the trade. *See id.* ¶ 35. This five-day lag time provided a window of opportunity to commit the fraud. Basically, during this period, Adler was forced to assume the validity of a given trade because the information concerning it came solely from Hanover. *See id.* ¶ 34. The largest alleged monetary loss occurred during the five business day period between Friday, February 17, 1995 and Monday, February 27, 1995. [FN3]

FN3. Perhaps not coincidentally, the fraud allegedly began on a Friday in order to take maximum advantage of the fact that it took five *business* days to settle a trade.

With this background information in mind, I turn to a more detailed discussion of the first scheme. As noted above, reacting to the scheme initiated by the defendants in the Gurian Proceeding, the defendants in this proceeding attempted to counteract the downward pressure on the House Stocks. Defendants did this by recording phony "purchases" of the House Stocks in customers' accounts. *See id.* ¶ 41. The purpose of this phony purchasing was to make it appear as if the House Stocks had a greater value than they in fact had. *See id.* Even though the customers never authorized these buys, their accounts were debited. *See id.* At the same time, Hanover was also recording fake "buys" in its proprietary accounts. *See id.* All of these transactions were secured by the then artificially inflated value of the House Stocks. *See id.*

***3** Given the volume of phony trading, *see id.* ¶ 42, and contrary to defendants' intention to prop up Hanover's financial position, Hanover was rapidly reaching the point of bankruptcy. Simply put, although the artificially inflated value of the House Stocks created the appearance of a strong net capital position, this position was nothing but a mirage supported by trades that never happened at prices that were illusory. In reality, the House Stocks were virtually worthless. *See id.* ¶¶ 42-44. The defendants allegedly knew this and, in an attempt to save the Favored Customers from a fate similar to the one rapidly engulfing Hanover, hatched the second scheme. *See id.* ¶ 45.

Integral to an understanding of the second scheme is some basic information concerning SIPA coverage. When a brokerage house fails, SIPA generally honors customer claims for up to $500,000, up to $100,000 of which can be for cash. *See id.* ¶ 47. In the first instance, Adler guaranteed Hanover's trades, *see id.* ¶¶ 8 & 44, but once Adler's resources were exhausted, SIPA would cover the remainder. Defendants allegedly knew that given the volume of phony trading, Adler could not guarantee all of the fake trades, but they expected SIPA coverage to provide the rest. *See id.*

The point of the second scheme was to protect

Hanover's Favored Customers by providing them with maximum SIPA coverage in the hope that defendants would be able to keep them as customers after Hanover's inevitable collapse. *See id.* On February 17, 1995, the defendants began to shift the Favored Customers' anticipated losses to Adler and SIPC. *See id.* ¶ 48. The Favored Customers were heavily invested in the House Stocks. *See id.* In its final week, Hanover's Favored Customers "sold" $31.5 million in House Stocks. *See id.* The purported "buyer" was Hanover, through its proprietary accounts. *See id.* These "sales" were made at artificially high prices in order to create an inflated SIPA claim. *See id.* ¶ 49. But again, at this point in time, due to the success of the scheme alleged in the Gurian Proceeding and the failure of these defendants' first scheme, the House Stocks were virtually worthless. *See id.* This created a vicious circle. In order to keep the Favored Customers happy, defendants sought to create inflated SIPA claims. In order to do this, defendants needed to maintain the value of the House Stocks for as long as possible. This in turn led to more fake "buying," and Hanover continued to spiral downward into financial ruin. *See id.*

In addition to Hanover's fake "buying" of the Favored Customers' positions in the House Stocks, Hanover was also "selling" the Favored Customers' positions for cash credits. *See id.* ¶ 51. In an attempt to obtain for the Favored Customers the best SIPA coverage, the defendants used these cash credits to turn the Favored Customers' accounts into cash (up to $100,000, the maximum cash coverage provided by SIPA) and the remainder in Blue Chip stocks. *See id.* Because SIPA coverage is based on the value of the underlying instruments, transferring the positions in the House Stocks to Blue Chips ensured the highest possible claim. Notably, during this time period, the Favored Customers purchased Blue Chips in amounts that they never previously purchased during Hanover's relationship with Adler. *See id.* ¶ 52. [FN4] Moreover, the Trustee has obtained a number of statements from Favored Customers, some more explicit than others, that the defendants took these actions without the approval of the Favored Customers. *See id.* ¶¶ 53-58.

FN4. More specifically, $17.6 million of the Blue Chip "buying" (or 94% of it) was concentrated in eight stocks: Apple, Dell, Ford, Cisco Systems, IBM, AT & T, Birmingham Steel and Microsoft. Prior to the final week, during the entire time that Hanover cleared through Adler, all Hanover customers (not just the Favored Customers) bought: $0 of Apple, $464,569 of Dell, $287,805 of Ford, $188,767 of IBM, $9,128 of Cisco Systems, $5,223 of AT & T and $68,405 of Birmingham Steel. Prior to the final week, Favored Customers had *never* purchased Apple, Ford, IBM or AT & T. *See* Complaint ¶ 52.

***4** The extent of the harm caused by this scheme is revealed by the sheer volume of fake trading. For the period from February 17 through 24, Hanover booked $59.2 million in "buys" of House Stocks into its customer accounts. Using a "conservative assumption," $45 .1 million of these "buys" were fake. Using other less conservative methods, it appears that Hanover's customers only acknowledge $2.9 million in legitimate buys, less than 5% of the $59.2 million in "buys" booked during this final week. *See id.* ¶ 50. Because Hanover had no money, and its customers never "purchased" anything, Adler and SIPC covered these "transactions." *See id.* ¶ 51; *see also id.* ¶¶ 8 & 44. All told, in the final week of Hanover's existence, the Favored Customers (who overall represent a "small" percentage of the Hanover Customers invested in the House Stocks) "sold" 80% of their House Stocks. *See id.* ¶ 59.

DISCUSSION

Collectively, the defendants (but in some instances not all of them) make the following arguments in support of their motions to dismiss: (1) the Trustee's claims are not timely; (2) the Complaint fails to allege a section 10(b) violation as a matter of law; (3) the Complaint fails to plead both its section 10(b) allegations, and its section 20(a) and common law fraud claims, with sufficient particularity; and (4) that some allegations should be stricken as irrelevant and inflammatory. These arguments are addressed in turn below.

I. *Statute of Limitations*

In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 501 U.S. 350, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991), the Supreme Court held that the statute of limitations for section 10(b) claims is one year from the date of discovery, but in no event longer than three years from the date of the alleged fraud. *See id.* at 358-63. Both sides agree that this

action is timely only if the provisions of 11 U.S.C. § 108(a) apply, and this, accordingly, is the issue to be decided. For the following reasons, I hold that the action was timely commenced.

Title 11, section 108 provides, in relevant part, as follows: "If applicable nonbankruptcy law ... fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of--(2) two years after the order for relief." 11 U.S.C. § 108(a). Defendants do not dispute that the technical aspects of this rule have been complied with, *i.e.*, the statute of limitations did not expire before the filing of the petition and the Trustee timely commenced it within two years of the order for relief. Instead, they make two arguments as to why it should not apply. First, defendants contend that a SIPA trustee is not entitled to the additional time. Second, defendants appear to argue that this provision should not apply to section 10(b) claims because of language in *Lampf* which refers to the statute of limitations as a "period of repose." 501 U.S. at 363. I reject both arguments.

***5** First, in reliance upon *AMS Realty, Inc v. Tao (In re AMS Realty, Inc.),* 114 B.R. 229 (Bankr.C.D.Cal.1990), defendants assert that section 108 does not apply to SIPA trustees. There, the court held that a Chapter 7 trustee could not obtain the benefit of section 108 because the complaint at issue had been filed after the two-year extension. *See id.* at 232. In a footnote, and apparently in dicta, the court also stated: "It should be noted that § 108(a) could only be utilized by a trustee or a Chapter 11 debtor in possession, *not a Chapter 7 Trustee.* Collier on Bankruptcy, Vol. 4, ¶ 108.02, p. 108-6." *Id.* at 232 n. 1 (emphasis added). Defendants argue that because a SIPA trustee is most analogous to a liquidating trustee in a Chapter 7 proceeding, under the "rule" articulated in *AMS Realty,* a SIPA trustee should not be entitled to rely upon section 108.

As the Trustee correctly argues, it appears that this language from *AMS Realty* was a typographical error or otherwise unintentional. Section 108 refers to "the trustee" without any qualifications, as *AMS Realty* recognized in the beginning of this footnote where the court referred to "a trustee or a Chapter 11 debtor in possession." The court likely intended to state that section 108 does not apply to chapter 7 *debtors,* as opposed to chapter 7 *trustees.* This is borne out by the passage from Collier that the *AMS Realty* court specifically cited and relied upon, which reads as follows: "[T]he benefits of subsections (a) and (b), which refer to *the trustee,* do not pass to *a debtor in a case under chapter 7,* or under chapter 11 or 12 when a trustee has been appointed and the debtor is no longer a debtor in possession." 2 Lawrence P. King, *Collier on Bankruptcy* § 108.02[4], at 108-6 (15th ed.1998) (emphasis added). In addition, this reading is consistent with the decisions of a number of courts that have held that section 108 applies to chapter 7 trustees. *See, e.g., Brandt v. Parke (In re Foos),* 204 B.R. 545, 548 (Bankr.N.D.Ill.1997); *Estate of B.J. McAdams, Inc. v. Sugar Foods Corp.,* 171 B.R. 12, 14 (S.D.N.Y.1994); *Askanase v. Fatjo,* 828 F.Supp. 465, 470 (S.D.Tex.1993). Accordingly, even assuming, arguendo, that a SIPA trustee is most like a chapter 7 trustee, because a chapter 7 trustee can invoke section 108, so, too, can a SIPA trustee. *See Federal Ins. Co. v. Sheldon,* 150 B.R. 314, 320 (S.D.N.Y.1993) ("Section 108 of the Bankruptcy Code, which applies to SIPA liquidations pursuant to 15 U.S.C. § 78fff(b) ...."); *see also In re Lloyd Sec., Inc.,* 163 B.R. 242, 257 (Bankr.E.D.Pa.1994) (indicating in dicta that "[i]t is not at all clear to us that the broad language of 11 U.S.C. § 108(a) would not have preserved the timeliness of the [SIPA] Trustee's claims"), *aff'd in part and rev'd in part on other grounds,* 183 B.R. 386 (E.D.Pa.1995), *aff'd on other grounds,* 75 F.3d 853 (3d Cir.1996).

***6** Second, defendants, in an almost off--handed reference to the Supreme Court's choice of language, argue that because *Lampf* created a "period of repose" section 108 should not apply. Other than basically stating as much, defendants do not elaborate upon, or otherwise address, this mere embryo of an argument. Some hint of the argument they may be making can be gleaned from the portion of the decision where this phrase ("period of repose") first appears-- where the Court held that the doctrine of equitable tolling does not apply to section 10(b) claims. *See Lampf,* 501 U.S. at 363. After noting that time limitations are "customarily subject to equitable tolling[,]" *id.* (internal quotation marks and citation omitted), the Court nonetheless held that the doctrine did not apply to the statute of limitations it announced because the three-year time

limit "is a period of repose inconsistent with tolling." *Id.* One could argue that because the Court held that equitable tolling does not apply to section 10(b) claims, section 108, which operates as an extension of the statute of limitations, should not as well.

While such an argument is not without its appeal, it must ultimately fail. Section 108 does not operate like an equitable toll--it is not indefinite in effect (an equitable toll, at least conceptually, has no outer limitation) and it does not hinge upon considerations of equity. Rather, section 108 applies for a fixed period of time under a limited set of circumstances, and it exists by statute, which statute leaves no room for an argument of non-application based upon a particular set of circumstances, equitable or otherwise (section 108 applies to "applicable nonbankruptcy law" without apparent limitation). [FN5] Accordingly, I find that section 108 applies to section 10(b) claims. *Cf. Durso Supermarkets, Inc. v. D'Urso (In re Durso Supermarkets, Inc.),* No. 94 Civ. 6035(LLS), 1995 WL 739549, at *7 (S.D.N.Y. Dec. 14, 1995) (reaching the same result without addressing this issue).

FN5. One could argue that the word "applicable" somehow limits the federal laws to which the provision applies, but the Supreme Court has interpreted the identical language in another context broadly, so as to include both federal and state law without any indication that it is limited to particular federal statutory schemes. *See Patterson v. Shumate,* 504 U.S. 753, 757-58, 112 S.Ct. 2242, 119 L.Ed.2d 519 (1992).

II. *Section 10(b) Claims--Standing*

Both the Court of Appeals and the Supreme Court have made clear that only a purchaser or seller of securities may bring an action under section 10(b). *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 731-34, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975); *Birnbaum v. Newport Steel Corp.,* 193 F.2d 461, 464 (2d Cir.), *cert. denied,* 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952). The issue in this case is whether plaintiff, as the trustee for a clearing firm, satisfies this requirement. For the reasons that follow, I hold that he does and, therefore, defendants' motions to dismiss on this ground are denied.

As a clearing firm, Adler's role in the transactions at issue is well-defined and can be summarized as follows: "[T]he introducing firm gathers the information from the customers and the clearing broker processes the information. In other words, the clearing firm makes sure that the trading orders gathered by the introducing broker are carried out (*i.e.,* the money and securities are sent to the right accounts)." Complaint ¶ 5; *see also* Complaint ¶¶ 30-31. *See generally* Henry F. Minnerop, *The Role and Regulation of Clearing Brokers,* 48 Bus. Law. 841, 841-43 (May 1993) (discussing the role and functions of a clearing firm). In addition, and most importantly, Adler performed a guarantee function--if a purchase did not clear, a seller could collect the purchase price from Adler. *See* Complaint ¶¶ 8 & 44. Here, defendants argue that Adler is not a purchaser within the meaning of *Blue Chip* because: (1) Adler only performed clearing and settlement functions and never "actually purchased securities in reliance upon any act or omission of anyone;" and (2) the allegations in the Complaint concerning Adler's guarantee function do not support a forced purchaser theory as a matter of law. *See* Ageloff Mem. at 14-15; Ageloff Reply Mem. at 15-23. [FN6]

FN6. In their discussion concerning section 10(b)'s "in connection with" requirement, defendants make another argument that I have treated as a variation of their standing arguments. *See infra,* Part III.

***7** The first argument ignores the Complaint's central allegation, which, in the context of this motion, I must accept as true. The essence of the Trustee's claim is that Adler became a forced purchaser of the fake buys after Hanover's collapse, which collapse triggered Adler's guarantee function, and that the defendants intended this result in order to protect the Favored Customers. *See* Complaint ¶¶ 6-8, 44, 63 & 65. In brief, as set forth above, defendants allegedly moved their Favored Customers out of the House Stocks by arranging fake buys of those stocks from purported individual purchasers. *See id.* ¶ 7. In fact, the real purchaser was Hanover, but Hanover had no funds. *See id.* When Hanover was forced to close, Adler was in turn forced to guarantee the fake buys and to pay out approximately $70 million to the Favored Customers for their "sales" of the House Stock. *See id.* ¶ 8. In other words, Adler was forced to purchase, from the Favored Customers at artificially

high prices, the House Stocks that were the subject of the fake buys ostensibly executed by Hanover. *See id.* ¶¶ 44 & 48-49. Adler, therefore, has alleged that it "actually purchased" securities--in the sense that, as a result of its guarantee function, it paid the Favored Customers the "sale" price for the House Stocks at issue--and that it did so in reliance upon acts and omissions of the defendants--in the sense that Adler cleared the fake trades, and thus guaranteed them, in reliance upon the defendants' false representations that the trades were genuine.

The second argument, that Adler was not a forced purchaser as a matter of law, turns on defendants' argument that Adler "was a guarantor of [Hanover's] creditworthiness, not a purchaser." Ageloff Mem. at 15; Ageloff Reply Mem. at 15. While it is true that Hanover's financial collapse, *i.e.,* lack of creditworthiness, triggered subsequent events, this argument ignores the fact that that collapse, coupled with Adler's guarantee, forced Adler to purchase the House Stocks in order to cover the fake buys. Adler was therefore more than a "guarantor of [Hanover's] creditworthiness," Adler's guarantee function resulted in purchases of the House Stocks.

At least two courts in this district have specifically held that a clearing firm has standing to maintain a section 10(b) cause of action. *See Epstein v. Hass Sec. Corp.,* 731 F.Supp. 1166, 1183-84 (S.D.N.Y.1990); *Bradford Sec. Processing Serv., Inc. v. County Federal Savings and Loan Assoc.,* 450 F.Supp. 208, 209-10 (S.D.N.Y.1978). [FN7] Other courts, under similar circumstances, have reached the same result. *See A.T. Brod & Co. v. Perlow,* 375 F.2d 393, 395-97 & n. 3 (2d Cir.1967) (broker had standing where it was "compelled" to sell, at a loss, securities it was holding for a client who refused to pay for them); *Rooney Place, Inc. v. Reid,* 605 F.Supp. 158, 160-61 (S.D.N.Y.1985) (following *A.T. Brod* under virtually identical circumstances); *Jefferies & Co. v.. Arkus-Duntov,* 357 F.Supp. 1206, 1213 (S.D.N.Y.1973) (broker had standing where it was an "involuntary purchaser" because, "for reasons beyond its control," it ended up purchasing fraudulently issued stock (citing *American Bank & Trust Co. v. Barad Schaff,* 335 F.Supp. 1276 (S.D.N.Y.1972))). Indeed, in this bankruptcy proceeding, Judge Garrity reached the same conclusion in a related matter under similar facts. *See Joseph Roberts & Co. v. Mishkin (In re Adler, Coleman Clearing Corp.),* Case No. 95 B 08203(JLG), Adv. Pro. No. 95/8266A, slip. op. at 24-25 (February 7, 1997 Bankr.S.D.N.Y.). As a result, the Trustee's theory that it became a forced purchaser of the securities by virtue of its guarantee function is enough to maintain standing under *Blue Chip* and its progeny. *Cf. Mallis v. FDIC,* 568 F.2d 824, 829-30 (2d Cir.1976) (holding that a pledgee who assumes the risk that pledged securities will have continuing value has assumed "a risk that is identical in nature to the risk taken by investors" and that such a pledgee has standing under *Blue Chip* to maintain a section 10(b) claim) (internal quotation marks and citation omitted), *cert. dismissed,* 435 U.S. 381, 98 S.Ct. 1117, 55 L.Ed.2d 357 (1978); *Vine v. Beneficial Finance Co.,* 374 F.2d 627, 633-35 (2d Cir.1967) (holding that plaintiff who was forced to sell shares after a short form merger had standing to bring a section 10(b) claim), *cert. denied,* 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967). *But cf. Isquith v. Caremark Int'l, Inc.,* 136 F.3d 531, 535-37 (7th Cir.1998) (expressing criticism of the "defunct forced-seller doctrine" and the Court of Appeals' decision in *Vine*) (Posner, J.).

FN7. Defendants attempt to distinguish *Epstein* by noting that there the clearing broker held the securities it paid for (as a result of its guarantee function) as a general lien against any amounts owed by the customers. *See* 731 F.Supp. at 1184. The Complaint herein does not contain a similar allegation, and defendants argue that this difference compels a different result. I disagree. First, I note that regardless of whether Adler holds the securities as a lien, it paid for them. *Epstein* concerned the same situation, *see id.,* and this is the critical point. Second, although the complaint in *Epstein* contained a general allegation concerning the ability to hold securities as a lien, plaintiff had not specifically alleged that it was holding the particular securities at issue as a lien against money owed. Nonetheless, the court was willing to "infer this from asserted facts." *Id.* For much the same reason, I am willing to infer the general existence of a lien in this matter since liens of this nature appear to be standard in the industry. Moreover, in his opposition memorandum of law, the Trustee specifically points out that its agreement with Hanover provides for just such a lien. *See* Trustee Mem. at 13 n. 7. Defendants do not dispute this fact, they only argue that it is contained in the memo of law and not the Complaint.

> Since I am granting the Trustee the right to amend, the Trustee may include this specific allegation in the amended complaint.

III. *Section 10(b) Claims--The "In Connection With" Requirement*

***8** Under section 10(b), a plaintiff must allege that a fraud was perpetrated "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. The Court of Appeals has held that "[t]he Act and Rule impose liability for a proscribed act in connection with the purchase or sale of security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a necessary part." *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir.1984), *cert. denied*, 469 U.S. 884, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984). Interpreting this decision, district courts in this circuit have universally held that misrepresentations or omissions involved in a securities transaction, but not pertaining to the securities themselves, cannot form the basis of a section 10(b) claim. *See, e.g., Production Resource Group, L.L.C. v. Stonebridge Partners Equity Fund, L.P.*, No. 98 Civ. 466(MGC), 1998 WL 278300, at *4 (S.D.N.Y. May 22, 1998); *Press v. Chemical Investment Services Corp.*, 988 F.Supp. 375, 389 (S.D.N.Y.1997); *Bissell v.. Merrill Lynch & Co.*, 937 F.Supp. 237, 242 (S.D.N.Y.1996); *Levitin v. PaineWebber, Inc.*, 933 F.Supp. 325, 328 (S.D.N.Y.1996); *Manufacturers Hanover Trust Co. v. Smith Barney, Harris Upham & Co.*, 770 F.Supp. 176, 181 (S.D.N.Y.1991). Stated somewhat differently: " 'the 'in connection with requirement' mandates that the alleged fraud concern the fundamental nature of the [securities]: namely, characteristics and attributes that would induce [an] investor to buy or sell the particular securities." ' *Manufacturers Hanover*, 770 F.Supp. at 181 (quoting *Kearney v. Prudential- Bache Sec., Inc.*, 701 F.Supp. 416, 424 (S.D.N.Y.1988)); *see also Production Resources*, 1998 WL 278300, at *4. More recently, some courts have further distilled this concept to the requirement that the fraud must relate to the value of the securities. *See, e.g., Press*, 988 F.Supp. at 389; *Bissell*, 937 F.Supp. at 242; *Vigilant Ins. Co. v. C & F Brokerage Servs.*, 751 F.Supp. 436, 438 (S.D.N.Y.1990).

Here, defendants make three arguments in support of their position that the Complaint fails to meet this requirement. First, defendants argue that the alleged fraud did not concern "fundamental characteristics and attributes" of the securities. Second, they argue that Adler did not make any investment decisions and simply processed trades. Stated more colorfully, Ageloff alleges that Adler "was a large, complicated machine that processed trades" and nothing more. Ageloff Mem. at 16. Third, defendants claim that Judge Sweet's decision in *Alex Brown & Sons Inc. v. Marine Midland Banks, Inc.*, No. 96 Civ. 2549(RWS), 1997 WL 97837 (S.D.N.Y. March 6, 1997) is "indistinguishable" from this case and mandates dismissal. For the reasons that follow, I find that the Trustee has satisfied his burden of pleading fraud "in connection with the purchase or sale of any security."

***9** The first argument, that the alleged fraud did not concern fundamental attributes of the stock, misses the point. The Complaint specifically alleges the following, all of which concern a stock's fundamental attributes: (1) the defendants lied to Adler when they told it that there were real buyers for the House Stocks in an attempt to make it appear that there was a stable market for the House Stocks (Complaint ¶ 4); and (2) the defendants booked "sales" of the House Stocks at artificially high prices in order to obtain a higher SIPA liquidation claim when in fact there never were any "sales" and when the value of the House Stocks was far less than the price of the purported sales (Complaint ¶ 49); *see also* Complaint ¶ 64. A stable market, purported buyers and artificially high prices, all of these characteristics of a stock pertain to a stock's "fundamental nature" and are "characteristics and attributes that would induce [an] investor to buy or sell the particular securities." *Manufacturers Hanover*, 770 F.Supp. at 181 (internal quotation marks omitted).

Defendants' second argument is that Adler did not make any investment decisions, but rather simply processed trades. In making it, defendants rely upon an oft-quoted passage from *Chemical Bank* in which Judge Friendly explained the reasons for the court's interpretation of the "in connection with requirement" discussed above:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions--to make sure that buyers of securities get what they think they are getting and that sellers of

> securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

726 F.2d at 943. From this point of reference, defendants basically argue that the Trustee fails to plead fraud "in connection with the purchase or sale" of securities because Adler never made a purchase, or an investment decision, in reliance upon anything the defendants said or did; rather, Adler processed trades and was only a guarantor that had no choice in the matter once Hanover collapsed. *See* Ageloff Mem. at 16. As the Trustee puts it, in an equally colorful gloss on Ageloff's "machine" analogy, Adler was a "machine that processed trades that, once turned on, could not be turned off." Trustee Mem. at 18.

To a certain extent, this is a bit like an argument looking for a home. The "in connection with requirement" focuses on whether the fraud relates to the characteristics of the securities themselves or something else which only incidentally involves securities. The requirement does not concern itself with what the plaintiff did with the fraudulently conveyed information. True enough, Judge Friendly's reasoning, in focusing on the "purpose" of the Act and the Rule, discusses the matter in terms that support defendants' argument, but that general reasoning should not be elevated to a specific requirement in the absence of some authority for doing so. The defendants have not cited any such authority. Rather than attempt to force this argument into the "in-connection- with" hole, it is more accurate to view it either as a variation of the standing argument (*i.e.*, Adler was not a purchaser because it did not make investment decisions) or as a type of causation argument.

***10** In a general sense, the former point has already been addressed, and, inasmuch as a forced purchaser, by definition, makes a purchase not based upon an independent deliberative process, but because some outside circumstance compels the transaction, Adler need not have made an independent investment decision prior to purchase in order to be a purchaser within *Blue Chip*. *See A.T. Brod,* 375 F.2d at 395-97 & n. 3 (holding that broker who was "compelled" to sell securities had standing to maintain a section 10(b) cause of action even though, by virtue of this compulsion, the broker was not an "investor" because the broker was "clearly a purchaser of securities"); *Vine,* 374 F.2d at 635 (rejecting argument that a plaintiff "cannot be a defrauded seller because nothing was asked of him, no representations were made to him--indeed ... nothing had to be communicated to him" and instead reasoning that it is "precisely because [defendant] gives no choice to [plaintiff] ... and the [plaintiff] must now exchange his shares for cash that [plaintiff] can now be deemed a seller"). Indeed, in *Blue Chip* the Court reasoned that establishment of the actual purchase or sale requirement has the benefit of creating a standard that depends upon an "objectively verifiable fact." 421 U.S. at 747. Requiring a plaintiff also to demonstrate, at the standing stage of the analysis, that the purchase was made as a result of an independent deliberative process, a wholly subjective inquiry, runs counter to that reasoning. Here, the "objectively verifiable fact" is that Adler, based on the facts then known to it, assumed a guarantee function and, as a result, paid out nearly $70 million to the Favored Customers based on purchases that were never made at prices that were fraudulently inflated. *See* Complaint ¶¶ 7-8. Nothing more is required.

On the latter point, the Court of Appeals has held that "[a] statement cannot be fraudulent if it did not affect an investment decision of the plaintiff." *Mills v. Polar Molecular Corp.,* 12 F.3d 1170, 1175 (2d Cir.1993). Defendants seize upon the phrase "affect an investment decision" and argue that because Adler did not make "an investment decision," it cannot sustain this cause of action. There are two problems with this argument; one as a matter of law, the other as a matter of fact.

First, *Mills* did not involve a forced purchase or sale. In such cases, because the purchase or sale is forced, it is not the result of a plaintiff's "investment decision" (assuming, arguendo, that "investment decision" refers to a plaintiff's independent determination that a particular purchase or sale is a good idea) but rather is the result of some other set of circumstances that compel the plaintiff to enter into a transaction--here, Adler's guarantee. *See Mallis,* 568 F.2d at 829-30 (pledge agreement compelled a sale and purchase); *Vine,* 374 F.2d at 635 (short form merger statute compelled the sale). I do not read *Mills* as somehow overruling the line of cases that discuss the forced

purchaser doctrine.

***11** Second, and perhaps more important, in the usual case, a clearing firm performs the somewhat ministerial task of clearing trades. In these circumstances, it does not make independent investment decisions. Nonetheless, and generally speaking, clearing firms retain the right to refuse to clear a trade. *See generally* Minnerop, *supra,* Bus. Law. at 845 ("Clearing firms seek to minimize their risk further by reserving the right to reject or terminate any introduced account and to decline to execute or clear any introduced order for the purchase or sale of securities for any reason."). More specifically, Adler has alleged that had it known the truth behind defendants' various misrepresentations, it would not have continued to clear Hanover's trades. *See* Complaint ¶ 64; *see also id.* ¶ 4. In this sense, Adler was not a forced purchaser inasmuch as Adler had a choice as to whether it would clear Hanover's trades and only did so in reliance upon Hanover's fraudulent misrepresentations. *See Isquith,* 136 F.3d at 535 (describing a forced purchase as a purchase which results from "compulsion" and contrasting that to a non-forced sale in which the purchaser is "induced" into the transaction). Accordingly, the fraud alleged herein did "affect an investment decision" in the broader sense of a decision that involves an investment-related activity-- whether Adler would clear, and thus guarantee, Hanover's trades.

Finally, I reach defendants' specific reliance upon *Alex Brown.* There, Alex Brown & Sons Inc. ("Alex Brown") was a clearing broker for Monness, Crespi, Hardt & Co. ("Monness Crespi"). Defendant Marine Midland Bank ("Marine") acted as a custodian and paying agent for Stanley I. Berk, along with two other entities controlled by Berk (collectively, "Berk"). Marine extended credit to Berk and paid for securities purchased by Berk. *See Alex Brown,* 1997 WL 97837, at *1. Berk directed Monness Crespi to make several trades, and Alex Brown acted as clearing agent. Marine "affirmed" these trades, which means that Marine reviewed them, determined that the quantity, price, net purchase money and account instructions comported with Berk's instructions, and represented to Alex Brown that the trades would settle as scheduled. *See id.* at *2.

Without discussing the details of why what should have been a straightforward transaction went awry (*see id.* at *2- *3 for Judge Sweet's discussion of those details), for present purposes it suffices to observe that the fraud alleged by Alex Brown "relate[d] to whether Berk had funds available to effectuate the purchases." *Id.* at *5. Applying the rule articulated in the cases discussed *supra,* Judge Sweet concluded that "Alex Brown fails to state a claim for securities fraud because the alleged misrepresentations and omissions pertain not to the securities themselves, but to the status of Berk's credit and the availability of funds in his account." *Id.* at *6. Again, the defendants here argue that Alex Brown is "indistinguishable" and that its reasoning "squarely" applies. Ageloff Mem. at 17. I disagree.

***12** Alex Brown's complaint failed to state a claim because the fraud pertained to Berk's credit and the availability of funds in Berk's account. Admittedly, issues concerning Hanover's creditworthiness and the availability of its funds are not irrelevant to this matter. It was the collapse of Hanover's creditworthiness and its inability to pay for the fake "buys" that led to Adler being forced to guarantee these transactions. But the alleged fraud also related to other matters; namely, as discussed *supra,* whether there was a stable market for the House Stocks, whether there were buyers for the House Stocks and whether the defendants accurately represented the value of the House Stocks. Alex Brown did not make such allegations, and the decision is, therefore, distinguishable. *See Production Resource Group,* 1998 WL 278300, at *4 (observing that in *Alex Brown* the court held that the claim should be dismissed because "the alleged misrepresentation did not 'relate to the fundamental investment attributes of the securities' but instead related to whether the purchaser of the securities had funds available to effectuate the purchases." (quoting *Alex Brown,* 1997 WL 97837, at *5)). [FN8]

FN8. Nonetheless, the defendants are correct that, in this sweeping complaint, some of the Trustee's allegations concern matters that are not related to the House Stocks' fundamental attributes. For example, the Trustee alleges that Hanover was in violation of its minimum net capital requirement and that Hanover intentionally failed to disclose this fact to Adler. *See* Complaint ¶¶ 43-44. While such an allegation may be sufficient to state a claim for common law fraud, it is, in light of the standard for

> the in connection with requirement, not a proper allegation of securities fraud. This claim, basically that Hanover could not afford to purchase the House Stocks that it was purportedly buying, is virtually identical to the type of fraud that Judge Sweet found non-actionable in *Alex Brown*. Accordingly, the Trustee may not proceed on this theory under its section 10(b) and rule 10b-5 cause of action.

IV. *Failure to State a Claim and Sufficiency of the Pleadings*

Many of the defendants made motions to dismiss for either failure to state a claim under Fed. R. Civ. P 12(b)(6) or failure to plead fraud with the requisite level of particularity under Fed.R.Civ.P. 9(b), or both. These two inquiries are distinct and are analyzed separately below. In addition, some of the defendants' claims are addressed separately because of the different roles the defendants played in the alleged schemes. For the reasons that follow, these motions are granted in part and denied in part.

A. *Ageloff*

Defendant Ageloff makes two distinct arguments as to why the Complaint should be dismissed as against him. The first, brought pursuant to Fed.R.Civ.P. 12(b)(6), is based upon his view that the Complaint fails to allege, as a matter of law, that he is a primary violator of section 10(b). For the reasons that follow, this aspect of the motion is denied. Second, as to all three of the causes of action--the section 10(b), controlling person liability and New York Common law claims--Ageloff argues that the Complaint does not set forth its allegations with sufficient specificity. For the reasons that follow, this aspect of the motion is granted.

1. *Federal Security Claims--Failure to State a Claim as a Matter of Law*

Two important decisions form the backdrop to this portion of the motion to dismiss. In *Central Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), the Supreme Court held that a litigant may not bring a cause of action for aiding and abetting a section 10(b) violation, and in *Dinsmore v. Squadron, Ellenoff,* 135 F.3d 837 (2d Cir.1998), the Court of Appeals held, for virtually the same reasons, that a cause of action does not exist for conspiracy to violate section 10(b). As a result, the only form of section 10(b) liability which remains viable is primary liability. Ageloff contends that the Trustee has not alleged that he is a primary violator. For the reasons that follow, I disagree, and this aspect of the motion is denied.

***13** Ageloff asserts that "[t]here are no particulars about anything that Ageloff ever said to or withheld from Adler, Coleman. To the contrary, the Complaint concedes that Adler, Coleman did not receive any information from Ageloff whatever." Ageloff Mem. at 21 (citing Complaint ¶ 34). In reliance upon, *inter alia, In re MTC Elec. Techs. Shareholder Lit.,* 898 F.Supp. 974 (E.D.N.Y.1995) , *reargument granted and vacated in part on other grounds,* 993 F.Supp. 160 (S.D.N.Y.1997), Ageloff argues that the Trustee fails to state a claim because "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)." *Id.* at 987; *see also* Ageloff Mem. at 20. According to Ageloff, the holding in *MTC Elec.* is consistent with the broader implications of *Central Bank* and the conclusion that Ageloff is not a primary violator of the securities laws because the Complaint does not allege that he ever made a false statement to Adler.

The Trustee responds by arguing that Ageloff is liable as a primary violator because *"Central Bank* does not purport to protect from liability those who direct and coordinate fraudulent conduct simply because those lower down the chain of command were primarily responsible for implementing the fraud." Trustee Mem. at 27. For this proposition, the Trustee relies upon the Court of Appeals' decision in *SEC v. First Jersey Securities, Inc.,* 101 F.3d 1450 (2d Cir.1996), *cert. denied,* --- U.S. ----, 118 S.Ct. 57, 139 L.Ed.2d 21 (1997). More specifically, and critical to resolution of this motion, the Trustee argues that such a theory is supported by the holding in *First Jersey:*

> Primary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration." *Azrielli v. Cohen Law Offices,* 21 F.3d 512, 517 (2d Cir.1994).

101 F.3d at 1471. The Trustee relies upon other authorities to similar effect. *See In re U.S.A. Classic Sec. Lit.,* No. 93 Civ. 6667(JSM), 1995 WL 363841, at *5 (S.D.N.Y. June 19, 1995) ("*Central*

Bank does not limit the liability of those who participate in a scheme to defraud[.]"); *Primavera Familienstifung v. Askin,* No. 95 Civ. 8945(RWS), 1996 WL 494904, at *7 (S.D.N.Y. Aug. 30, 1996) (same), *reargument granted and vacated in part on other grounds,* 1996 WL 580917 (S.D.N.Y. Oct.9, 1996). Based upon these legal theories, the Trustee basically argues that it is irrelevant that Ageloff did not make any direct representations to Adler because it is sufficient, particularly under *First Jersey,* that Ageloff "coordinated and directed sophisticated securities frauds[.]" Trustee Mem. at 28.

The starting point for resolving this dispute is the decision upon which the Trustee places principal reliance, *First Jersey.* There, the SEC brought an enforcement action against, *inter alia,* Robert E. Brennan ("Brennan") based on both primary and controlling person liability. After a lengthy bench trial, the district court found Brennan liable on both counts. *See* 101 F.3d at 1460- 61 & 1471. On appeal, Brennan disputed the adequacy of both findings, but the Court of Appeals affirmed. *See id.* at 1472-74.

***14** With respect to primary liability, the Court of Appeals agreed with the district court that "the degree of oversight needed to coordinate the activities carried out by dozens of branch offices throughout the United States, and hundreds, if not thousands, of sales representatives, supports the ... determination that the illegal activity [engaged in by the defendant corporation] could only have occurred at the direction of First Jersey's upper- level management, [*i.e.,* Brennan]." *Id.* at 1471. The Court of Appeals also agreed with the district court that Brennan "engaged in purposeful planning of the pattern and repeated format of trading in which the respective branch offices engaged and that he orchestrated every facet of First Jersey's branch office network." *Id.* at 1471-72 (internal quotation marks and citation omitted).

In opposing these findings, Brennan argued, in reliance upon *Universal Heritage Investments Corp.,* 47 S.E.C. 839 (1982), that his conduct amounted only to controlling person, not primary, liability. The Court of Appeals disagreed and held that because Brennan "orchestrated" and was "intimately involved in" or had "hands on involvement in" the critical decisions, his liability was more than just controlling person liability. *See id.* at 1472 (internal quotation marks and citation omitted). In brief, the Court of Appeals held that Brennan was liable as a primary violator because he "orchestrated" the fraud engaged in by First Jersey. *See id.*

As quoted above, *First Jersey* appeared to reach this result in reliance upon the view that primary liability remains where an individual has " 'knowledge of the fraud and assisted in its perpetration." ' 101 F.3d at 1471 (quoting *Azrielli,* 21 F.3d at 517). *First Jersey* was decided after the Court's decision in *Central Bank.* Much like this knowledge and assistance standard, in *Central Bank,* the Tenth Circuit had held that aiding and abetting liability attaches where, *inter alia,* there is: "[1] recklessness by the aider and abettor as to the existence of the primary violation; and [2] substantial assistance given to the primary violator by the aider and abettor." *Central Bank,* 511 U .S. at 168 (citation omitted). Of course, the Court rejected the view that such a theory of liability exists in a section 10(b) cause of action. Comparing the knowledge and assistance standard in *First Jersey* to the standard rejected by the Court in *Central Bank,* it appears that the two are virtually identical, and that *First Jersey* is therefore inconsistent with *Central Bank.*

More directly, the authority which *First Jersey* relied upon and quoted from, *Azrielli,* is a pre-*Central Bank* decision (in fact, it was decided a mere thirteen days before *Central Bank*). *Azrielli,* in turn, relied exclusively upon that portion of *IIT Int'l Investment Trust v. Cornfeld,* 619 F.2d 909, 927 (2d Cir.1980), in which the Court of Appeals adopted and set forth the elements for an aiding and abetting cause of action. *See Azrielli,* 21 F.3d at 517 (discussing *IIT Int'l Investment Trust,* 619 F.2d at 922-927). Indeed, in *Central Bank,* the dissent cited *IIT Int'l Investment Trust* as the representative decision from the Court of Appeals in which the Second Circuit recognized a private cause of action for aiding and abetting liability. *See Central Bank,* 511 U.S. at 192 n. 1; *see also Wright v. Ernst & Young LLP,* No. 97-9241, 1998 WL 455600, at *7 (2d Cir. Aug. 6, 1998) (noting that the knowledge and substantial assistance prongs of *IIT Int'l Investment Trust* "are two of the three prongs for pre-*Central Bank* aiding and abetting liability"). As a result, it appears that the knowledge and assistance standard adopted in *First Jersey* is identical to the aiding and abetting standard rejected by the Court in *Central Bank. Cf. In re Blech Sec. Lit.,* 961 F.Supp.

569, 584 (S.D.N.Y.1997) (citing *Azrielli* as a pre-*Central Bank* case in which the Court of Appeals set forth the standard for aiding and abetting liability and holding that such a claim is not viable after *Central Bank*); [FN9] *Lycan v. Walters,* 904 F.Supp. 884, 901 n. 12 (S.D.Ind.1995) (declining to follow *Azrielli* because it predates *Central Bank* and is inconsistent therewith). *But see In re Health Management, Inc. Sec. Lit.,* 970 F.Supp. 192, 209 (E.D.N.Y.1997) (following *First Jersey* and the knowing and assistance standard to uphold a section 10(b) cause of action).

FN9. Interestingly, in a footnote, *Blech* indicated that the Court of Appeals "has provided some guidance on the fate of claims against 'secondary' actors" and specifically quoted from the knowing and assistance language in *First Jersey.* 961 F.Supp. at 583 n. 5. The *Blech* court, also in this footnote, noted that *First Jersey* relied upon *Azrielli. See id.* It was, however, only in the body of the opinion that *Blech* specifically pointed out that *Azrielli* was a pre-*Central Bank* decision that adopted an aiding and abetting standard. *See id.* at 584.

***15** The net effect of all of this strongly suggests that the knowledge and assistance standard adopted in *First Jersey* is inconsistent with the holding of the Court in *Central Bank.* Because the Trustee places virtually exclusive reliance upon it, this would seem to require granting Ageloff's motion. Indeed, two more recent decisions from the Court of Appeals intimate that the court recognizes as much and is retreating from the holding in *First Jersey.*

In *Shapiro v. Cantor,* 123 F.3d 717 (2d Cir.1997), the Court of Appeals addressed a private action claim against, among others, an accounting firm. The court noted that in *First Jersey* it held "the president of a brokerage firm primarily liable for *orchestrating* the manipulative acts of multiple branch offices in the sale of securities at excessive prices." *Id.* at 720 (emphasis added and citation omitted). Immediately following this characterization of the holding, the court began a passage that appears to indicate a retreat from this holding:

> Some district courts within this circuit have strictly applied the holding of *Central Bank.* For example, in *In re MTC Elec. Techs. Shareholder Litig.,* 898 F.Supp. 974, 987 (E.D.N.Y.1995), the district judge concluded:
>
> [I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under section 10(b). [FN10]
>
> FN10. I note here that this is the same authority which Ageloff relies upon in his moving memorandum of law, and to which the Trustee countered by relying upon *First Jersey.*
>
> *See also In re JWP Inc. Sec. Litig.,* 928 F.Supp. 1239, 1255-56 (S.D.N.Y.1996) (dismissing misrepresentation claims against audit committee defendants where those defendants did not actually make the misrepresentations). Similarly, the Tenth Circuit observed:
>
> Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver,* we conclude that in order for accountants to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided "significant" or "substantial" assistance to the representations of others.
>
> *Anixter v. Home-Stake Prod. Co.,* 77 F.3d 1215, 1226-27 (10th Cir.1996).

Shapiro, 123 F.3d at 720 (footnote not in original). After discussing these authorities, the Court of Appeals held, in contrast to the knowing and assistance standard discussed in *First Jersey,* that [a]llegations of "assisting," "participating in," "complicity in" and similar synonyms ... all fall within the prohibitive bar of *Central Bank.* A claim under § 10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security. *McMahan & Co. v. Wherehouse Entertainment, Inc.,* 900 F.2d 576, 581 (2d Cir.1990).

***16** *Id.* at 720-21 (footnote omitted). Thus, *Shapiro* strongly suggests that "orchestration" of

misstatements or omissions is not enough to sustain primary liability, and that a plaintiff must allege, as Ageloff argues herein, that a defendant made a material misstatement or omission in order to be liable under section 10(b).

In *Wright v. Ernst & Young LLP,* No. 97-9241, 1998 WL 455600 (2d Cir. Aug.6, 1998), which also involved an action against an accounting firm, the Court of Appeals reaffirmed the holding in *Shapiro* against an attempt to rely upon *First Jersey. See id.* at *1,*4 & *6- *8. Nonetheless, the court's discussion of *First Jersey* is a bit more equivocal on the question of its ongoing vitality than language in *Shapiro* may have otherwise suggested:

> [In *First Jersey,* w]e held Brennan liable for securities fraud in his capacity as a "controlling person," that is, for fraud planned and directed by upper level management. Here, we confront fraud alleged by accountants-- secondary actors who may no longer be held primarily liable under § 10(b) for mere knowledge and assistance in the fraud.

Id. at *7 (citation omitted). As discussed in greater detail below, by contrasting the holding in *First Jersey* in this manner, the Court of Appeals suggested that *First Jersey* is distinguishable from *Shapiro* and *Wright* and that the holding may still be relevant notwithstanding *Shapiro'* s implications. This still leaves the problem, however, of how to reconcile *First Jersey'* s knowledge and assistance standard with *Central Bank.* [FN11] The last of the quartet of cases relevant to this dispute solves that aspect of the puzzle.

> FN11. Curiously, and perhaps mindful of this very issue, the court pointed out that in 1995, in the Private Securities Litigation Reform Act ("PSLRA"), Congress granted the SEC the authority to bring enforcement actions against individuals who " 'knowingly provide[ ] substantial assistance to another person." ' *Id.* at *7 (quoting 15 U.S.C. § 78t(f)). *First Jersey* was an SEC enforcement action, but this provision was not discussed in *First Jersey,* and the timing issues are not entirely clear. *See SEC v. U.S. Environmental, Inc.,* 1998 WL 559027, at *6 (2d Cir. Aug. 25, 1998) (discussing this same provision and noting that it "remains unclear" whether the SEC can rely upon it for conduct that occurred prior to passage of the PSLRA). In any event, unlike *First Jersey,* this action is a private action, and in *Wright* the court specifically indicated that this provision "did not create a private cause of action." 152 F.3d 169, 1998 WL 455600, at *7.

In *SEC v. U.S. Environmental, Inc.,* No. 97-6195, 1998 WL 559027 (2d Cir. Aug.25, 1998), in contrast to both *Shapiro* and *Wright,* the Court of Appeals addressed a claim asserted against a non-secondary actor, John Romano ("Romano"). Romano was a registered trader with one of the defendant broker- dealers, Castle Securities Corporation ("Castle"). The amended complaint alleged that Romano engaged in a scheme to inflate the value of the stock of U.S. Environmental ("USE"). In addition, the amended complaint alleged that Romano engaged in this scheme with Mark D'Onofrio, USE's stock promoter. *See id.* at *1.

The district court granted Romano's motion to dismiss pursuant to Rule 12(b)(6) on the sole ground that the SEC had not alleged that Romano was a primary violator as required by *Central Bank.* The district court reasoned that Romano only "follow[ed] directions from D'Onofrio" and "did not himself make" any unlawful sales. *See id.* at *2 (internal quotation marks and citation omitted). Moreover, the district court held that where a claim is based on a market manipulation theory, a manipulative intent is required, as opposed to mere knowledge or recklessness, and that Romano did not "manipulate USE stock because he did not himself have a manipulative purpose." *Id.* (internal quotation marks and citation omitted).

***17** In reversing the district court's order, the Court of Appeals cited and discussed *First Jersey* and *Shapiro.* Significantly, however, the Court of Appeals did not refer to either the knowledge and assistance standard articulated in *First Jersey* or the must-make-a-statement-or-omission standard of *Shapiro. See id.* at *3 & *5. Instead, the court focused on the critical reasoning of *Central Bank* which emphasized that primary liability attaches to those who " 'engage in the manipulative or deceptive practice." ' *Id.* at *3 (quoting *Central Bank,* 511 U.S. at 167). The court emphasized similar language from *First Jersey* and observed "that a primary violator is one who 'participated in the fraudulent scheme' or other activity proscribed by the securities laws." *Id.* (quoting *First Jersey,* 101 F.3d at 1471).

Applying this standard to the allegations in the amended complaint, the Court of Appeals concluded that primary liability was properly alleged:

> Romano ... did not simply fail to disclose information when there was no duty to do so, as in *Shapiro,* or fail to prevent another party from engaging in a fraudulent act, as in *Central Bank,* when there existed no duty to prevent such. Rather, Romano himself "commi[tted] a manipulative act," *Central Bank,* 511 U.S. at 177, by effecting the very buy and sell orders that manipulated USE's stock upward.

U.S. Environmental, 1998 WL 559027, at *5. In more powerful terms, the Court of Appeals held that "if the trader who executes manipulative buy and sell orders is not a primary violator, it is difficult to imagine who would remain liable after *Central Bank." Id.*

A few points about alleging primary liability under section 10(b) emerge from reading these cases together. First, to the extent that *Shapiro* suggested that *First Jersey* was wrongly decided, *Wright,* and more forcefully *U.S. Environmental,* confirm that that is not the case. In *Wright* the court appeared to distinguish it, and in *U.S. Environmental* the court affirmatively relied upon it. As a result, *First Jersey* is still controlling, but two pressing questions remain with regard to its relevance to the present dispute: (1) what effect, if any, does *Shapiro'* s holding that a primary violator must actually make a material misstatement have with regard to the Trustee's claims; and (2) what is the status of the holding in *First Jersey* that knowledge and assistance is sufficient to establish primary liability.

Turning to the first question, in *U.S. Environmental* the Court of Appeals made clear that making a material misstatement or omission, as required under *Shapiro,* is but one of two ways to prove primary liability. *See* 1998 WL 559027 at *5 (section 10(b) " 'prohibits only the making of a material misstatement (or omission) *or* the commission of a manipulative act" ' (quoting *Central Bank,* 511 U.S. at 177) (emphasis added)). Again, it is significant that while discussing *Shapiro* in *U.S. Environmental,* the Court of Appeals never suggested that Romano was not liable because he did not make a material misstatement or omission. Instead, the court focused exclusively on whether he engaged in a manipulative act. Accordingly, and notwithstanding the holding in *Shapiro,* Ageloff is incorrect in arguing that he must, in order to be a primary violator, make a material misstatement or omission. [FN12]

> FN12. It is also worth noting that both *Shapiro* and *Wright* (as well as *Central Bank*) involved so-called secondary actors in the securities markets, *i.e.,* accountants and lawyers. *Shapiro* and *Wright* both struggled with the very difficult question of how to allege primary liability as to those actors, which, as *Central Bank* discussed at some length, involves unique policy and statutory construction issues. In contrast, *First Jersey* and *U.S. Environmental* both involved non- secondary actors, or individuals who work exclusively in the securities industry, *i.e.,* brokers, traders and principals in broker-dealers. Part of what may have troubled the courts in both *Shapiro* and *Wright* vis-a- vis *First Jersey* is the problem of importing a standard of liability for non-secondary actors into a secondary actor context. This is not to suggest that the two standards are never interchangeable, they may very well be. I do not express an opinion on this issue (even assuming it to be an "issue"), I only point this out to suggest that some of the problems in interpreting *First Jersey* through the lenses of both *Shapiro* and *Wright* may be explained by this distinction.

***18** This leaves unresolved the second problem, *i.e.,* what to make of the knowledge and assistance standard articulated in *First Jersey.* As discussed *supra,* I have little doubt that *Azrielli* is no longer good law after *Central Bank,* and that a plaintiff cannot establish primary liability by alleging knowledge of a fraud and assistance therein, as suggested by *First Jersey.* Nonetheless, the conduct engaged in by Brennan in *First Jersey* seems as if it should amount to something more than aiding and abetting liability. What intuition suggests *U.S. Environmental* confirms. Indeed, the court cited and discussed specific language from *First Jersey* which indicates that in *First Jersey* the court may have been relying upon the same standard articulated in *U.S. Environmental, i.e.,* participating in a fraudulent scheme or committing a fraudulent act. In any event, Brennan's conduct, when analyzed under that standard of liability, was sufficient to establish primary liability. By "orchestrat[ing]" the fraud and by virtue of his "hands-on involvement" in it, Brennan participated in a fraudulent scheme. Accordingly, while the Trustee errs in relying upon

the knowledge and assistance standard of *First Jersey,* the result reached in *First Jersey* is in accord with the theory of liability articulated in *U.S. Environmental.*

This is an awfully long journey to reach the ultimate issue that must be resolved here: whether the complaint pleads, as a matter of law, that Ageloff is a primary violator of section 10(b). I find that it does. For the reasons stated above, the Trustee need not allege that Ageloff made a material misstatement; it is enough if the Complaint alleges that Ageloff participated in a fraudulent scheme or committed a fraudulent act. I recognize that *U.S. Environmental* involved a trader, and Ageloff argues that he was not a trader but only a supervisor. However, nothing in *U.S. Environmental* even remotely suggests that the standard it articulated is limited to traders. In the absence of such a *per se* prohibition, the only issue is whether Ageloff, a non-trader, can meet that standard since he did not, as did Romano, actually execute trades.

For many of the same reasons that Brennan in *First Jersey* could be liable under this standard, so, too, can Ageloff. Like Brennan, Ageloff is alleged to have "initiated, approved, directed, and carried out the entire scheme." Complaint ¶ 60(a). In addition, the Complaint alleges that Ageloff was the "primary undisclosed principal behind Hanover, and the sales manager for Hanover's brokers." *Id.* ¶ 14. Other allegations are to a similar effect. *See, e.g., id.* ¶ 37 (alleging that "real control of the firm rested with" Ageloff; that Ageloff and Catoggio "ran the company" and possessed contracts giving them up to 65% of Hanover's profits; and that Ageloff "shouted, threatened and physically attacked Hanover's brokers"); *id.* ¶ 69 (alleging that Ageloff and Catoggio "through intimidation or otherwise held the most authority at the firm, including the ability to hire and fire employees"; that they "monitored all of the brokers and oversaw all of the trading and sales activity" and that they "were able to control every facet of Hanover's operations").

***19** Accordingly, Ageloff's Rule 12(b)(6) motion must be denied. Much like the claims of "orchestrat[ion]" in *First Jersey,* the Complaint alleges a level of participation in the fraud sufficient to hold that, in the context of this motion, Ageloff participated in a fraudulent scheme. As *U.S. Environmental* makes clear, that is enough to allege primary liability. The question of whether, under Rule 9(b), the Complaint's allegations are sufficiently specific is a separate and distinct question, and it is that matter that I turn to next.

2. *Federal Security Claims--Sufficiency of the Pleadings*

I turn now to that portion of Ageloff's motion which argues that the Complaint's allegations are not pled with sufficient particularity. Ageloff makes this claim with respect the section 10(b), controlling person and New York common law of fraud claims. In the analysis that follows I first set forth the Complaint's allegations concerning Ageloff. Second, I address the standard to be applied to such a motion with respect to each of these claims. Third, I apply these standards to the allegations in the Complaint. For the reasons that follow, I hold that the Complaint, as to Ageloff, does not plead these claims with the requisite specificity.

a. *The Allegations Against Ageloff*

The Complaint alleges, and I must accept as true, the following relevant facts. In the broadest and most conclusory of terms, the Complaint generally alleges that Ageloff "initiated, approved, directed, and carried out the entire scheme." Complaint ¶ 60(a). Ageloff was also the "primary undisclosed principal behind Hanover, and the sales manager for Hanover's brokers." *Id.* ¶ 14. Finally, Ageloff was partially responsible for negotiating the contract between Hanover and Adler. *See id.* ¶ 5.

At its most specific, the Complaint alleges as follows:

> [R]eal control of the firm rested with a violent and domineering man, Ageloff, and his associate, Catoggio, the head trader. Although the regulatory records do not indicate that the two were officers or owners, Ageloff and Catoggio, ran the company, and they had contracts giving them up to 65% of Hanover's profits. Ageloff was the sales manager, and he shouted, threatened and physically attacked Hanover's brokers. Ageloff and Catoggio had a special recording device that enabled him to listen in on the calls of any broker. The Trustee is aware of no significant meetings at Hanover at which either Ageloff or Catoggio or both did not participate.

Complaint ¶ 37. In addition, the Complaint alleges that

> Ageloff and Catoggio through intimidation or otherwise held the most authority at the firm, including the ability to hire and fire employees. They monitored all of the brokers and oversaw all of the trading and sales activity. Working directly with Hanover brokers in Hanover's New York office and monitoring and controlling all trading from Hanover's Florida office, Ageloff, Catoggio, Schatzer, and Ashenfarb were able to control every facet of Hanover's operations. All four were directly involved in the fraud, deceit, and market manipulation described herein.

***20** Complaint ¶ 69.

These allegations constitute the totality of the allegations concerning Ageloff. With them in mind, I turn to the standards to be applied to determine their sufficiency.

b. *Section 10(b) Claims*

In 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA"), and its passage has generated considerable confusion on the question of the controlling standard for pleading a section 10(b) claim. Relevant to the present matter is section 21(b)(2), which provides as follows:

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2). The issue that has generated the confusion is exactly how this "strong inference" standard relates to prior decisions by the Court of Appeals in which this standard was first articulated. The Trustee invites me to avoid this debate by stipulating that, under even the most stringent standard, the Complaint adequately alleges a section 10(b) violation. *See* Trustee Mem. at 24 n. 12. Under the circumstances, I accept the invitation and address the debate only briefly to set forth precisely what the most stringent standard is.

Prior to the PSLRA's passage, the Court of Appeals held that a section 10(b) claim, which is subject to Fed. R. Civ. Proc. 9(b), must satisfy two distinct but related pleading requirements. First, because Rule 9(b) provides that "the circumstances constituting fraud ... [must] be stated with particularity[,]" the Court of Appeals required a plaintiff to: " '(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." ' *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1127-28 (2d Cir.1994) (quoting *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir.1993) (citation omitted)). This standard, or one nearly identical to it, was codified in the PSLRA. *See* 15 U.S.C. § 78u-4(b)(1). Second, although Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally," the Court of Appeals required plaintiffs "to allege facts that give rise to a strong inference of fraudulent intent" in order to give meaning to Rule 9(b)'s overall purpose. *See Shields*, 25 F.3d at 1128; *see also Chill v. General Elec. Co.*, 101 F.3d 263, 267 (2d Cir.1996). A "strong inference" can be shown either "(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Shields*, 25 F.3d at 1128; *see also Chill*, 101 F.3d at 267.

***21** As noted *supra*, section 78u-4(b)(2) of the PSLRA adopted the Court of Appeals' "strong inference" standard. Although that would perhaps seem to resolve the matter, the question is whether Congress also adopted the various means of proving that standard, *i.e.*, motive and opportunity and strong circumstantial evidence of conscious misbehavior or recklessness. Courts have reached different conclusions. *See, e.g., Novak v. Kasaks*, 997 F.Supp. 425, 429-30 (S.D.N.Y.1998); *In re Gelnayre Tech., Inc. Sec. Lit.*, 982 F.Supp. 294, 297-98 (S.D.N.Y.1997); *In re Health Management*, 970 F.Supp. at 200-01; *In re Baesa Sec. Lit.*, 969 F.Supp. 238, 241-42 (S.D.N.Y.1997); *Norwood Venture Corp. v. Converse Inc.*, 959 F.Supp. 205, 208 (S.D.N.Y.1997). [FN13] Although these courts have debated the question of whether the motive and opportunity prong, along with the recklessness standard, survive adoption of section 78u-4(b)(2), no one disputes that the conscious misbehavior standard remains viable inasmuch as that is the most

stringent of the three formulations. *See Friedberg v. Discreet Logic Inc.*, 959 F.Supp. 42, 49 & n. 2 (D.Mass.1997) (indicating that the conscious misbehavior standard is more restrictive than both the motive and opportunity and recklessness standards). As a result, I shall apply this standard to the Complaint.

FN13. Cases addressing this split are pending in the Ninth and Sixth Circuit Courts of Appeals. *See* Dominic Bencivenga, *Appeal Reveals Reform Act's Tortured History*, N.Y.L.J., June 11, 1998, at 5.

The problem with the Complaint is not so much that it fails to allege facts to support the inference that Ageloff engaged in conscious misbehavior, the problem is that the Complaint does not provide, with any degree of specificity, facts concerning what Ageloff is alleged to have done. As a result, Ageloff's motion must be granted, not because the Complaint fails to adequately plead scienter, but because, pursuant to the first aspect of Rule 9(b), the Complaint fails to allege "with particularity" the "circumstances constituting fraud[.]" To be sure, the fraud itself is described in considerable detail, as discussed *supra* and as addressed in more detail *infra* in connection with the allegations against the other defendants. But as to Ageloff's role in the fraud, most of the Complaint's allegations speak in broad and conclusory terms about what he did without providing any specific information. A few examples illustrate the point.

The Complaint alleges that Ageloff was "a violent and domineering man" and that he "shouted, threatened and physically attacked Hanover's brokers." Complaint ¶ 37. These allegations are pled without connecting this conduct to the alleged fraud. Did Ageloff physically attack Hanover's brokers in order to compel them to execute trades? If so, when and where did he do so, and what exactly did he do? The answers to these questions provide the type of information that Rule 9(b) requires, but which the Complaint noticeably lacks. Similarly, the allegation that Ageloff possessed "a special recording device that enabled him to listen in on the calls of any broker[,]" Complaint ¶ 37, tells us nothing, without more, about how Ageloff utilized this device, common in this industry, in furtherance of the fraud. The same problem exists with respect to the claim that Ageloff "monitored all of the brokers and oversaw all of the trading and sales activity." Complaint ¶ 69. There is nothing else alleged about that activity that helps to provide specific information as to how precisely that conduct is linked to the fraud. Finally, the Complaint alleges that "[t]he Trustee is aware of no significant meetings at Hanover at which either Ageloff or Catoggio or both did not participate." Complaint ¶ 37. Putting aside the somewhat awkward phrasing of this allegation, it, too, tells us nothing about what transpired at these "significant meetings" and whether the fraud was even discussed, let alone discussed by Ageloff. Assuming that he did discuss it, the Complaint should tell us when these meetings took place and some indication about what Ageloff is alleged to have said and how it relates to the fraud. For all of these reasons, I find that the Complaint fails to satisfy Rule 9(b)'s pleading requirements.

c. *Controlling Person Liability*

***22** Although one would think, and hope, that the standard to be applied to a motion to dismiss a section 20(a) claim is well-established, the opposite is all too unfortunately the case. *See, e.g., In re Health Management*, 970 F.Supp. at 205-06 (discussing the intra-circuit split); *In re Gaming Lottery Sec. Lit.*, No. 96 Civ. 5567(RPP), 1998 WL 276177, at *8 n. 11 (S.D.N.Y. May 29, 1998); *Baxter v. A.R. Baron & Co.*, No. 94 Civ. 3913(JGK), 1996 WL 586338, at *5- *6 (S.D.N.Y. Oct. 11, 1996); *Food & Allied Serv. Trades Dept. v. Millfeld Trading Co.*, 841 F.Supp. 1386, 1390-91 (S.D.N.Y.1994). In *Duncan v. Pencer*, No. 94 Civ. 0321(LAP), 1996 WL 19043 (S.D.N.Y. Jan.18, 1996), I discussed this conflict at some length, and the two lines of decisions it has generated. In the first, in reliance upon *Lanza v.. Drexel & Co.*, 479 F.2d 1277 (2d Cir.1973) and *Gordon v. Burr*, 506 F.2d 1080, 1081 (2d Cir.1974), the courts have held that a plaintiff must plead control and either scienter or culpable conduct in order to withstand a motion to dismiss. *See Duncan*, 1996 WL 19043, at *17. In the second, in reliance upon *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir .), *cert. denied*, 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980), the courts have held that only an allegation of control is necessary. *See Duncan*, 1996 WL 19043, at *17. In *Duncan*, I agreed with the reasoning of the courts in the second line of decisions. *See id.* at *17- *18. Ageloff makes two arguments, both of apparent first impression, in

support of his position that *Duncan,* and the cases which reached the same result, are no longer good law.

First, Ageloff argues that in *First Jersey* the Court of Appeals resolved the split when it set forth the controlling standard for establishing a prima facie case for a section 20(a) violation:

> In order to establish a prima facie case of controlling-person liability, a plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant, *see Marbury Management, Inc. v. Kohn,* 629 F.2d at 715-16, and show that the controlling person was " 'in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[ ]," ' *Gordon v. Burr,* 506 F.2d 1080, 1085 (2d Cir.1974) (quoting *Lanza v. Drexel & Co.,* 479 F.2d 1277, 1299 (2d Cir.1973) (en banc)). Control over a primary violator may be established by showing that the defendant possessed "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2.

101 F.3d at 1472-73. Ageloff contends that the court's citation to both *Gordon* and *Lanza* demonstrates that the first line of cases correctly resolved the matter (*i.e.,* that control and either scienter or culpable conduct must be alleged). In addition, Ageloff argues that by using the phrase "prima facie," *First Jersey* suggests that this requirement exists at the pleading stage. I disagree.

***23** Although the court does indeed refer to the elements of a "prima facie" case, *First Jersey* was not a pleading case--it was an appeal from a final judgment after a bench trial. As I, along with a number of other courts, have previously indicated, this distinction between procedural postures is critical. *See Duncan,* 1996 WL 19043, at *17; *see also In re Health Management,* 970 F.Supp. at 206; *Food & Allied Serv. Trades,* 841 F.Supp. at 1390. I am thus hesitant to conclude that *First Jersey* resolved the intra-circuit dispute. Furthermore, my hesitancy is heightened by the fact that the court's decision does not mention any of the growing number of district court decisions addressing this issue. *But see Novak v. Kasaks,* 997 F.Supp. 425, 435 (S.D.N.Y.1998) (applying *First Jersey* standard to a motion to dismiss without addressing the intra-circuit split). It would be awkward indeed to conclude that the Court of Appeals resolved an important intra-circuit split in a decision that does not address any of the lower court decisions discussing that split.

Ageloff's second argument is more persuasive. Again, relevant to this argument is section 21(b)(2) of the PSLRA, set forth for a second time below for ease of reference:

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2). As discussed above, *First Jersey* established that as part of a plaintiff's prima facie case, a plaintiff must show that "the controlling person was "in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[.]" " 101 F.3d at 1472 (quoting *Gordon v. Burr,* 506 F.2d 1080, 1085 (2d Cir.1974) (quoting *Lanza v. Drexel & Co.,* 479 F.2d 1277, 1299 (2d Cir.1973) (en banc))). As a result, because a section 20(a) plaintiff must *ultimately* establish a defendant's state of mind, the PSLRA requires a plaintiff, at the pleading stage, to allege particular facts that give rise to a "strong inference" of the requisite state of mind.

I emphasize the word "ultimately" because using it helps to understand precisely why the PSLRA requires me to depart from my prior decision in *Duncan.* One of the reasons it was not appropriate to require a plaintiff to plead scienter or culpable participation was because that requirement was viewed as an element that must be proven at trial, not at the pleading stage. *See Duncan,* 1996 WL 19043, at *17; *see also In re Health Management,* 970 F.Supp. at 206; *Baxter,* 1996 WL 586338, at *5- *6; *Food & Allied Serv. Trades,* 841 F.Supp. at 1390. Section 78u-4(b)(2) makes that distinction irrelevant because it specifically links its heightened pleading standard to any cause of action where a particular state of mind is an element of a plaintiff's case, regardless of the stage at which that element must be proven. Stated somewhat differently,

section 78u-4(b)(2) provides the bridge between pleading requirements and ultimate burden that was previously lacking, and dispositive, to the question of a party's initial pleading obligations. In short, I read section 78u-4(b)(2) as requiring compliance with its terms where, as is the case here, a plaintiff must ultimately prove a defendant's state of mind in order to prevail.

***24** In opposition to this view, one could argue that a plaintiff is only required to establish culpable participation if a defendant proves that he acted in good faith. One could further argue that this requirement, therefore, is not a factor that a plaintiff must establish in order to recover, but is only necessary, if at all, to rebut an affirmative defense that may or may not be raised by a defendant. *See, e.g., Duncan,* 1996 WL 19043, at *17; *In re Health Management,* 970 F.Supp. at 206; *Baxter,* 1996 WL 586338, at *5- *6; *Food & Allied Serv.,* 841 F.Supp. at 1390. From these two positions, one could conclude that section 78u-4(b)(2) does not apply to section 20(a) actions because a plaintiff *cannot* "recover money damages *only* on proof that the defendant acted with a particular state of mind[.]" 15 U.S.C. § 78u- 4(b)(2) (emphasis added). In other words, "proof that the defendant acted with a particular state of mind" is only necessary if the defendant comes forward with proof that he acted in good faith, and because not all defendants will be able to do that, section 20(a) claims do not necessarily require proof that a defendant acted "with a particular state of mind."

In light of *First Jersey,* this argument is no longer tenable. Although I do not read the Court of Appeals' use of the phrase "prima facie" as conclusively resolving the intra-circuit split, I cannot ignore the import of this phrase. In selecting this language, the Court of Appeals held that a plaintiff must make a showing, prior to the submission of any proof by a defendant, that the controlling person was "in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[.]" *First Jersey,* 101 F.3d at 1472 (internal quotation marks and citation omitted). The critical point is that this language imposes an initial burden, not just a burden if the defendant makes a showing of good faith. Accordingly, in order to prevail under section 20(a), a plaintiff must come forward with "proof that the defendant acted with a particular state of mind[.]" 15 U.S.C. § 78u-4(b)(2).

Having so held, I must address precisely how section 78u-4(b)(2)'s pleading requirements affect the applicable standard in a section 20(a) claim. Prior to passage of the PSLRA, courts had discussed the Court of Appeals' strong inference standard exclusively in connection with section 10(b) claims. This made perfect sense because that standard evolved in the context of those claims and because a majority of judges in this district had concluded that a plaintiff need not plead scienter or culpable conduct in order to state a claim under section 20(a). Because of my conclusion that section 78u-4(b)(2)'s strong inference standard applies to section 20(a) claims, I must now consider how that standard affects, at the pleading stage, the Court of Appeals' requirement that a defendant be "in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated by [the] controlled person[.]" In other words, I must determine how to apply in a section 20(a) cause of action the body of law that developed around the section 10(b) strong inference standard.

***25** At some level, the issue is really a semantic one. The phrase "strong inference" is ambiguous; defining it with equally ambiguous phrases--"strong circumstantial evidence of conscious misbehavior" or "motive and opportunity" (the pre-PSLRA paradigms for determining whether a "strong inference" has been alleged, *see supra*) or being "in some meaningful sense [a] culpable participant"--does not substantially advance the inquiry. Attempting to divine the distinctions between a "strong inference," "strong circumstantial evidence of conscious misbehavior" and being "in some meaningful sense [a] culpable participant" is, as Judge Newman observed in an entirely unrelated context, "an inquiry in the class of angelic terpsichore on heads of pins." *Ringgold v. Black Entertainment Telev., Inc.,* 126 F.3d 70, 75 n. 4 (2d Cir.1997). At the same time, these standards will be, and perhaps must be, ambiguous in order to provide a measure of flexibility for case-by-case adjudication. *Cf. In re Leslie Fay Cos. Sec. Lit.,* 871 F.Supp. 686, 693-94 (S.D.N.Y.1995) ("While in a perfect world liability would be color-coded in black and white, shades of gray are an inherent incident of our legal system."). But the present problem is not so much their inherent ambiguity (that, of course, is the next problem) as much as which equivalently ambiguous phrase should

control.

In resolving this issue, Congress did two relevant things with section 78u- 4(b)(2). First, Congress decided to make section 78u-4(b)(2)'s heightened pleading standard applicable to "any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind[.]" Accordingly, section 78u-4(b)(2), as I found above, is applicable to more than just section 10(b) claims--it is applicable to *"any* private action...." Second, because of this fact, and although the Court of Appeals previously applied its "strong inference" standard only to section 10(b) claims, I see no good reason to apply one strong inference standard to section 10(b) claims and another strong inference standard to section 20(a) claims. Accordingly, I shall apply the same "strong inference" standard I am assuming applies to the section 10(b) claims, *i.e.,* the Trustee must plead particularized facts of Ageloff's conscious misbehavior as a culpable participant in the fraud.

To summarize, at the initial pleading stage, and in order to withstand a motion to dismiss a section 20(a) claim, I hold that a plaintiff must allege: (1) an underlying primary violation; (2) control over the controlled person by the controlling person; and (3) particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud. [FN14]

> FN14. Notably, the Trustee takes the position that *First Jersey* resolves the intra-circuit split and that, in any event, the standard applicable in this circuit comports with the PSLRA. *See* Trustee Mem. at 44 nn. 19-20. Because I disagree with the Trustee's conclusions as to *First Jersey'* s import, and because I believe that the impact of the PSLRA on this question is an important one, I have addressed this issue at some length rather than simply accept the Trustee's concession.

Applying these standards to the allegations in the Complaint highlights the Complaint's deficiencies while pointing out its strengths. In brief, most of the allegations concern whether Ageloff exercised control over the defendants, but again, much as was true with the section 10(b) claims, say nothing about what he actually did in exercising that control.

***26** As the Court of Appeals explained in *First Jersey,* control can be "established by showing that the defendant possessed 'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." ' 101 F.3d at 1472-73 (quoting 17 C.F.R. § 240.12b-2)); *see also Baxter,* 1996 WL 586338, at *6 (discussing the factors courts examine to determine whether control has been sufficiently pled). Here, the Trustee relies upon the "or otherwise" language and argues that the Complaint's allegations are specific enough, at this stage, to satisfy its pleading obligation. I agree.

The Complaint alleges a number of facts from which a "reasonable inference" of control can be made: Ageloff's interest in the profits, ability to hire and fire employees, physical and verbal threats, active monitoring of employees and attendance at key meetings. *See, e.g., In re Health Management,* 970 F.Supp. at 205 ("In order to defeat a motion to dismiss at the pleading stage with regard to a 'controlling person' allegation, a plaintiff must plead facts which 'support a reasonable inference that [defendants] had the potential power to influence and direct the activities of the primary violator." ' (citing *Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp.,* 941 F.Supp. 1369, 1378 (S.D.N.Y.1996); *Food and Allied Service Trades Dep't. v. Millfeld Trading Co.,* 841 F.Supp. 1386, 1392 (S.D.N.Y.1994))); *Baxter,* 1996 WL 586338, at *6 (noting that courts can examine a "myriad of ... factors," including "indirect means of discipline or influence short of actual direction" (citing *Drobbin v. Nicolet Inst. Corp.,* 631 F.Supp. 860, 884 (S.D.N.Y.1986))). The essence of Ageloff's argument to the contrary is that each of these various facts, standing alone, does not satisfy the Trustee's pleading obligations. Putting aside whether that is in fact true, I must read the Complaint as a whole, not in the piecemeal fashion that Ageloff adopts. *See In re Leslie Fay Cos. Sec. Lit.,* 918 F.Supp. 749, 763 (S.D.N.Y.1996) (rejecting attempt to "isolate various indicia of control" and holding that court must "consider the total effect of the various indicia of control in combination"). Under such a reading, the allegations are sufficient.

The problem with these allegations is that while they adequately plead control, they do not adequately allege what Ageloff did in the course of

exercising that control. For the same reasons as I discussed in addressing the section 10(b) claims, the Complaint must provide some detail about what Ageloff is alleged to have done, and when he did it, in order for me to hold that the Complaint provides "particularized facts" of Ageloff's culpable participation. Because of the absence of these details, Ageloff's motion must be granted.

d. *New York Common Law of Fraud*

Finally, I turn to the New York common law fraud claim. Initially, it is not entirely clear the precise theory upon which the Trustee bases this claim, but it appears that the primary allegation is that Ageloff was a co-conspirator with Hanover's traders and brokers. *See* Ageloff Mem. at 30; *see also* Complaint ¶ 1. Regardless, such a claim must satisfy the pleading requirements of Rule 9(b), *see Cohen v. Koenig,* 25 F.3d 1168, 1174 (2d Cir.1994) , though obviously not the PSLRA's requirements.

***27** Contrasting the holding in *Cohen* to the allegations in the present matter highlights the Complaint's deficiencies. There, the Court of Appeals reasoned and held:

> [T]here can be no doubt that plaintiffs complied with the Rule's requirement that the complaint plead with particularity the facts and circumstances constituting the fraud itself.... Plaintiffs specified who was alleged to have made the false statements; and they stated the precise dates and places of the meetings at which they alleged the fraudulent statements were made.

Id. at 1173. Again, as discussed *supra,* the Complaint contains none of these details concerning Ageloff's role. Of course, as I have already held, Ageloff need not have made a misstatement, and therefore the precise holding in *Cohen* concerning who said what, and when and where it was said, is not applicable. Nonetheless, *Cohen* provides an indication of the type of detail that must be alleged in any fraud claim. Here, that detail, as to Ageloff, is not present, and, accordingly, Ageloff's motion to dismiss the state law fraud claim is granted as well.

B. *The Other Defendants*

The following defendants have also moved to dismiss the section 10(b) and New York common law fraud claims: Ronan Garber, Danny Garber, Dibella, Lembo, Wolf and Mancino. At bottom, these defendants argue that the Complaint does not adequately plead a section 10(b) claim. For the reasons that follow, these motions are denied.

1. *Federal Securities Fraud Claims*

Unlike Ageloff, all of these defendants were either traders or brokers at Hanover. Accordingly, the issues with respect to *First Jersey* and the precise type of claim that can be alleged are not relevant. In short, as to these defendants, the Complaint alleges what the Court of Appeals in effect characterized as the quintessential section 10(b) claim. *See U.S. Environmental,* 1998 WL 559027, at *5 ("Indeed, if the trader who executes manipulative buy and sell orders is not a primary violator, it is difficult to imagine who would remain liable after *Central Bank."*). The issue is whether these allegations have been adequately pled.

Notwithstanding my very specific findings as to the allegations concerning Ageloff's purported involvement in the fraud, even a cursory review of this Complaint reveals that it describes the alleged fraud in considerable detail. The Complaint, over the span of some fifty paragraphs, describes precisely how the Trustee believes that this complex fraud was perpetrated and how the defendants engaged in it. Those allegations have already been discussed at length and will not be repeated herein. Throughout this discussion, however, the Complaint refers, with some minor exceptions, to the defendants generally and does not separately delineate each defendant's role. It is this aspect of the Complaint that the defendants seize upon in moving to dismiss.

The law is well-settled that "[w]here multiple defendants are asked to respond to allegations of fraud, the complaint should inform each defendant of the nature of his alleged participation in the fraud." *DiVittorio v. Equidyne Extractive Indus., Inc.,* 822 F.2d 1242, 1247 (2d Cir.1987); *see also Oei v. Citibank, N.A.,* 957 F.Supp. 492, 518 (S.D.N.Y.1997) (same). Had the Complaint only contained such omnibus allegations, dismissal under this rule would perhaps be appropriate. But the Complaint alleges much more. With respect to these defendants, it moves from the general to the specific to provide, respectively, context and detail. And with respect to each of the defendants, after setting

forth the general background discussed above, the Complaint contains the type of detail required by Rule 9(b) and the Court of Appeals:

***28** Ronan Garber: As one of two traders, he knowingly booked into Adler's clearing system many of the fake transactions. Together with Catoggio, he entered into Adler's clearing system all of the fraudulent transactions. Garber also entered four trades into the clearing system that defrauded Adler of $68,000. On February 17, 21 and 23, 1995, Garber booked trades into his account after they occurred, netting himself a profit and guaranteeing a loss for the Hanover propriety accounts. But, given his knowledge of Hanover's financial condition, he knew that Adler would be stuck with the losses in Hanover's propriety accounts. Thus, when Garber entered these four trades, he knowingly deceived Adler concerning the true nature of those transactions, inducing Adler to clear those four trades to Adler's detriment. Garber also used cash in his own account to buy Blue Chips on February 23, thereby using his knowledge of Hanover's impending collapse to further the fraud against Adler.

John Lembo: He approved and carried out a major portion of the scheme. In particular, from February 17 through 24, he booked $6.1 million in sales of Favored Customer House Stocks, $4.6 million in Favored Customer Blue Chip buys, $7.1 million in fake "buys" in customer accounts, and $4.1 million in fake short sales in customer accounts. Further, Lembo sold the House Stocks in his own account and the accounts of two of his relatives on February 17 and 21 and used a portion of the proceeds to buy Blue Chips on February 21. Lembo also fraudulently changed several customer addresses in attempt to conceal the Defendants' scheme. Lembo's fraud and manipulation demonstrate his knowledge of Adler and Hanover's impending collapse and directly advances his and his family's own financial gain.

Joseph Dibella: He approved and carried out a major portion of the scheme. In particular, from February 17 through 24, 1995 he booked at least $13.4 million in sales of Favored Customer House Stocks, $11.1 million in Favored Customer Blue Chip buys, $10.5 million in fake "buys" in customer accounts, and $3.6 million in fake short sales in customer accounts. Evidence of Dibella's knowledge and intent can be found in his efforts, and the efforts of his assistant, Scarfone, to contact Favored Customers to inform them of fraudulent trades that he made to increase their SIPA claim. In addition, Dibella opened a fake account for a "Dr. Morris Sulman." He booked $61,000 in fake "buys" to that fake account. All of these representations were designed to make Adler clear fake transactions associated with sales from the real Dr. Morris Sulman and "buys" by a fake "Dr. Morris Sulman." These fake transactions, by helping to falsely portray a stable market for House Stocks, also contributed to the overall fraudulent scheme. Dibella also had $136,000 wired out of his personal account on February 21, demonstrating his knowledge of Hanover's and Adler's impending collapse.

Mark Mancino: From February 17 through 24, he booked at least $2 .7 million in sales of Favored Customer House Stocks and $84,000 in Favored Customer Blue Chip buys. Mancino also booked two trades that defrauded Adler of $23,000. On February 13, 1995, Mancino booked trades into his account after they occurred, netting himself a profit and guaranteeing a loss for the Hanover proprietary accounts. But, given his knowledge of Hanover's financial condition, he knew that Adler would be stuck with the losses in Hanover's proprietary accounts. Thus, when Mancino entered these two trades, he knowingly deceived Adler concerning the true nature of those transactions, inducing Adler to clear those two trades to Adler's detriment. Mancino also tried to take cash out of his personal account, and he sold House Stocks in the final week. These acts demonstrate his knowledge of the impending collapse of Hanover and Adler, and his willingness to use that knowledge to further the fraud against Adler.

***29** Chris Wolf: From February 17 through 24, he booked at least $1.0 million in sales of Favored Customer House Stocks, and $912,000 in fake "buys" in customer accounts. Wolf also attempted to send money out of his own account on February 21 and he bought Blue Chips for his own account on February 24. These acts demonstrate his knowledge of Hanover and Adler's impending collapse and his willingness to use that information to defraud Adler for his immediate financial gain.

Danny Garber: From February 12 through 24, he booked at least $147,000 in sales of Favored Customer House Stocks, $67,000 in Favored Customer Blue Chip buys, and $62,000 in fake "buys" in customer accounts. Garber also fraudulently changed four customer addresses in an effort to conceal from Adler (and others) the

Defendants' fraudulent and manipulative acts. These fake address changes contributed to the overall fraudulent scheme, and demonstrates his knowledge of Hanover and Adler's impending collapse.

Complaint ¶¶ 60(d), (e), (f), (g), (i) & (l). These allegations provide more than sufficient individual detail to satisfy Rule 9(b)'s pleading requirements: the Complaint provides specific dates, specific amounts, specific conduct and, when read against the equally detailed discussion of the precise nature of the fraud, why this activity was fraudulent. Indeed, this detail stands in complete contrast to the allegations concerning Ageloff. Again, nowhere in the Complaint does one find this type of information concerning his purported role in the fraud.

As to the related question of whether scienter has been alleged with the required specificity, the Complaint's allegations are similarly sufficient. Unlike some cases, the central allegation here is that these defendants engaged in an intentional scheme to defraud with full knowledge of all relevant facts. This is not a case where the Complaint alleges that the defendants were reckless with respect to the facts surrounding a fraud. Here, the scheme alleged could only be perpetrated by people with specific knowledge, and the Complaint sets forth sufficient factual allegations from which one can infer the requisite state of mind. For example, the allegations that some of these defendants changed the names and addresses of the customers supports the Trustee's claim that the defendants intentionally deceived Adler concerning the existence of the purported purchasers of the House Stocks. In addition, the detailed information concerning the specific trades these defendants engaged in--when read against the general background surrounding these trades and the conditions during this period of time--provides a factual basis from which an inference of conscious misbehavior can be drawn. More specifically, in light of the detailed discussion of the defendants' prior trading activity, and their virtually non-existent activity in Blue Chips, the deliberate act of trading in these securities at this specific point in time creates an inference of conscious misbehavior. *See* Complaint ¶¶ 52 & 59 . [FN15]

FN15. As discussed *infra,* note 18, I have also considered, in determining whether the requisite state of mind has been pled, alleged facts (which I must accept as true) regarding some defendants' refusal to provide discovery in connection with these matters.

***30** The Complaint also alleges a motive for the behavior--to curry favor with the Favored Customers in the hope that defendants would be able to keep them as customers after Hanover's collapse. *See* Complaint ¶¶ 9, 47 & 59; *see also In re Glenayre Tech.,* 982 F.Supp. at 298 (holding that although motive and opportunity, standing alone, are no longer sufficient to satisfy the "strong inference" standard, such facts are still relevant to the analysis provided that they are pled along with other facts). In fact, the Complaint contains detailed allegations to this effect based upon statements (which are themselves specifically disclosed in the Complaint) the Trustee received from a number of identified Favored Customers. *See* Complaint ¶¶ 53-59. For example, one letter from a Favored Customer, Jay Harris ("Harris), reveals that Harris' broker, Danny Garber, made trades on Harris' behalf without permission in order "to protect [Harris] on price ... and to further protect [Harris], [Garber] placed an order to purchase Dell Computer to cover any cash that might be in the account, since if the transactions were consummated, [Harris'] cash would exceed the insured maximum of $100,000." Complaint ¶¶ 53-54. Similarly, Dibella wrote a letter to one of the Favored Customers approximately four months after Hanover's collapse addressing the Blue Chip purchases and stating that "no other broker would have done what I did for you in order to protect your investments[.]" *Id.* at ¶ 57. Information from another Favored Customer indicates that Dibella purchased Blue Chips without the customer's authorization. *See id.* ¶ 55. These allegations are more than sufficient, at this stage, to satisfy the requirement that the Complaint allege that the defendants engaged in conscious misbehavior. I have considered defendants' other arguments and find them to be without merit. [FN16]

FN16. Because the Complaint satisfies the pleading requirements for the section 10(b) claims, I also find that the Complaint satisfies the requirements for pleading common law fraud. *See Scone Investments, L.P. v. American Third Market Corp.,* No. 97 Civ. 3802(SAS), 1998 WL 205338, at *10 (S.D.N.Y. April 28, 1998) ("[T]he elements of common law fraud are essentially the same as those which must be pleaded to establish a claim under § 10(b) and Rule 10b-5." (citing *Pits, Ltd. v. American Express*

Bank, Int'l, 911 F.Supp. 710, 719 (S.D.N.Y.1996))); *cf. Morse v. Weingarten,* 777 F.Supp. 312, 319 (S.D.N.Y.1991) (dismissing New York common law fraud claims after addressing section 10(b) claims because the elements of the common law fraud claims are "substantially identical to those governing § 10(b)").

V. *Motion to Strike Certain Allegations in the Complaint*

Some of the defendants also move, pursuant to Fed.R.Civ.P. 12(f), to strike certain statements in the Complaint. Ageloff, Catoggio and Danny Garber argue that the following allegations should be stricken: (1) that the defendants engaged in "unlawful and criminal acts of market manipulation" (Complaint ¶ 1); (2) that their actions were "criminal acts" (Complaint ¶ 9); and (3) that the "criminal conspiracy expanded dramatically" (Complaint ¶ 46). In addition, Catoggio moves to strike the allegations that he asserted his Fifth Amendment rights when deposed by the Trustee and that he has been fined and barred from the securities industry by the SEC for his role in manipulating the price of one of the House Stocks. *See* Complaint ¶¶ 15 & 38. For the reasons that follow, the motions are denied. [FN17]

FN17. Catoggio also points out that paragraph 16 of the Complaint incorrectly refers to Catoggio. This was apparently a typographical error, and the correct defendant should be Lowell Schatzer. The Trustee agrees. *See* Trustee Catoggio Mem. at 5 n. 2. Since I am granting the Trustee the right to amend the Complaint, this paragraph should be amended accordingly.

Fed.R.Civ.P. 12(f) provides: "[T]he court may order stricken from any pleading ... any redundant, immaterial, impertinent, or scandalous matter." The Court of Appeals has directed district courts to approach such motions with great caution: "[I]t is settled that the motion will be denied, unless it can be shown that no evidence in support of the allegation would be admissible.... Thus the courts should not tamper with the pleadings unless there is a strong reason for so doing." *Lipsky v. Commonwealth United Corp.* ., 551 F.2d 887, 893 (2d Cir.1976) (citations omitted). Where the motion is made on the grounds that the material has no evidentiary value, or is not relevant, the motion should generally be denied and such matters resolved at trial, not "on the sterile field of the pleadings alone." *Id.* In general, "[m]otions to strike are disfavored 'and will not be granted unless it is clear that the allegations in question can have no possible bearing on the subject matter.' " *Forschner Group, Inc. v. B-Line A.G.,* 943 F.Supp. 287, 291 (S.D.N.Y.1996) (quoting *von Bulow by Auersperg v. von Bulow,* 657 F.Supp. 1134, 1146 (S.D.N.Y.1987) (citation omitted)); *see also Barcher v. NYU School of Law,* 993 F.Supp. 177, 181 (S.D.N.Y.1998); *Wine Markets Int'l, Inc. v. Bass,* 177 F.R.D. 128, 133 (E.D.N.Y.1998) ("Because striking a portion of a pleading is often sought by the movant as a dilatory tactic, motions under Rule 12(f) are viewed with disfavor." (citing Wright & Miller, *Federal Practice and Procedure* § 1380 (2d ed.1990))); *Chacko v. Dynair Services Inc.,* No. 96 Civ. 2220(SJ), 1998 WL 199866, at *1 (E.D.N.Y. March 15, 1998) (characterizing the motion as an "extraordinary remedy"); *Werner v. Satterlee, Stephens, Burke & Burke,* 797 F.Supp. 1196, 1210 (S.D.N.Y.1992).

***31** The allegations that these defendants engaged in criminal misconduct, and conduct that resulted in Catoggio's censure, are relevant to this case. These matters relate to the Complaint's core allegations of fraud, not some peripheral and unrelated charge of wrongdoing having no relationship to the alleged misconduct. Accordingly, I cannot say, as the Court of Appeals requires, "that no evidence in support of the allegation would be admissible." *Lipsky,* 551 F.2d at 893. Other courts have reached the same conclusion under similar circumstances. *See, e.g., Velez v.. Lisi,* 164 F.R.D. 165, 166-67 (S.D.N.Y.1995) (refusing to strike allegations of perjury and criminal misconduct because they were "sufficiently related to the plaintiff's overall claim that defendants entered into and acted upon a conspiracy"); *Moy v. Adelphi Institute, Inc.,* 866 F.Supp. 696, 708-09 (E.D.N.Y.1994) (declining to strike allegations of prior plea to several crimes because, following *Lipsky,* such requests are best decided at trial); *Food and Allied Service,* 841 F.Supp. at 1392 (same result in a securities class action where the complaint alleged that one of the defendant corporation's officers and directors was the subject of a criminal investigation). *But cf. Morse v. Weingarten,* 777 F.Supp. 312, 319 (S.D.N.Y.1991) (granting motion to strike allegations concerning Michael Milkin's criminal

conviction and income level because these allegations were "immaterial and impertinent to this case and may be scandalous" and further finding that they "bear[ ] remotely on the merits of this case") (internal quotation marks omitted).

The same is true of Catoggio's claim concerning his invocation of the Fifth Amendment. I cannot say that no evidence in support of this claim would be admissible. *See Brink's Inc. v. City of NY,* 717 F.2d 700, 707-10 (2d Cir.1983) (holding that defendant's former and present employees' exercise of their Fifth Amendment privilege was admissible evidence in a civil action); *LiButti v. United States,* 968 F.Supp. 71, 73-74 (N.D.N.Y.1997) ("The Fifth Amendment precludes courts from drawing inferences adverse to defendants in criminal cases, but it 'does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them." ' (quoting *Baxter v. Palmigiano,* 425 U.S. 308, 318, 96 S.Ct. 1551, 47 L.Ed.2d 810 (1976))). [FN18]

FN18. In light of these principles, it is not inappropriate to consider this aspect of Catoggio's conduct (and Ronan Garber's conduct, who also asserted his Fifth Amendment rights) in determining whether the Complaint pleads state of mind with the requisite specificity. *See* Complaint ¶ 38. On this point, I also note that the Complaint alleges that the Trustee has attempted to serve subpoenas on both Lowell Schatzer and John Lembo, and that the Trustee has not been able to locate either one. *See id.* Again, I have considered these factors in determining whether the Complaint adequately alleges culpable conduct and the requisite state of mind.

VI. *Motion to Amend the Complaint*

The Trustee seeks leave to amend the Complaint in the event that I grant any portion of the defendants' motions. Because I have dismissed the complaint as to Ageloff, I consider this request under the well-established standard for such a motion. *See, e.g., Rackson v. Sosin,* No. 95 Civ. 1105(LAP), 1997 WL 786940 (S.D.N.Y. Dec.22, 1997) (collecting cases and addressing this standard). Although I recognize Ageloff's argument that the Trustee has had substantial time to investigate these claims, given the nature and extent of the general allegations pled thus far, I find that it is appropriate to permit the Trustee to provide, if he can, more detail concerning these claims. Accordingly, the Trustee may file an amended complaint within 30 days.

CONCLUSION

***32** For the reasons stated above, with the exception of the motion to dismiss the claims against Ageloff, the defendants' motions are denied. The Trustee may file an amended complaint within 30 days of the date of this Memorandum and Order. Counsel shall appear for a conference on November 11, 1998 at 4:00 p.m. in Courtroom 12A at 500 Pearl Street.

SO ORDERED:

END OF DOCUMENT

LEXSEE 1999 U.S. Dist. LEXIS 17665

RGB EYE ASSOCIATES, P.A., et al., Plaintiffs, VS. PHYSICIANS RESOURCE GROUP, INC., et al., Defendants.

Civil Action No. 3:98-CV-1715-D

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS, DALLAS DIVISION

1999 U.S. Dist. LEXIS 17665; Fed. Sec. L. Rep. (CCH) P90,711

October 27, 1999, Decided

October 27, 1999, Filed; October 28, 1999, Entered on Docket

DISPOSITION:
[*1] Defendants' motion to dismiss granted and the Physicians' claims under § 10(b) of the Exchange Act, Rule 10b-5, and § 20(a) of the Exchange Act dismissed with prejudice. Case dismissed without prejudice.

COUNSEL:
For RGB EYE ASSOCIATES, PA, ROBERT BURLINGAME, MD, JW EYE ASSOCIATES, PA, JEFFREY WHITMAN, MD, LAWRENCE A SHAFRON, MD, RC EYE ASSOCIATES, PA, RUDOLF CHURNER, MD, JMH EYE ASSOCIATES, PA, JOHN M HALEY, MD, SAW EYE ASSOCIATES, PA, SHELBY A WYLL, MD, plaintiffs: William B Finkelstein, Craig W Budner, Thomas W Paxton, Attorneys at Law, Hughes & Luce, Dallas, TX USA.

For TEXAS PRG V INC, TEXAS PRG VI INC, TEXAS PRG XV INC, TEXAS PRG II INC, TEXAS PRG III INC, defendants: Lawrence B Schreve, Attorney at Law, Andrews & Kurth, Houston, TX USA.

For TEXAS PRG V INC, TEXAS PRG VI INC, TEXAS PRG XV INC, TEXAS PRG II INC, TEXAS PRG III INC, defendants: Dennis N Ryan, Robert Benton Weathersby, Attorneys at Law, Andrews & Kurth, Dallas, TX USA.

For JEFFREY SCHILLER, DIVERSIFIED INVESTMENT HOLDINGS LP, movants: Marc R Stanley, Attorney at Law, Stanley Mandel & Iola, Dallas, TX USA.

JUDGES:
SIDNEY A. FITZWATER, UNITED STATES DISTRICT JUDGE.

OPINIONBY:
SIDNEY A. FITZWATER

OPINION:

MEMORANDUM [*2] OPINION AND ORDER

The dispositive question presented by defendants' motion to dismiss plaintiffs' federal securities law claims is whether plaintiffs have adequately pleaded scienter based on conscious or severely reckless behavior or motive and opportunity. Concluding that they have not, the court dismisses these claims. The court dismisses without prejudice the balance of this lawsuit because plaintiffs' federal declaratory judgment action does not invoke this court's original jurisdiction, the parties are not completely diverse citizens, and the court in its discretion declines to adjudicate what is otherwise a state-law case that is best litigated in a state forum.

I

A

Plaintiffs (collectively the "Physicians" or "plaintiffs" n1) are several ophthalmologists n2 and their respective professional associations. They sue defendants Physicians Resource Group, Inc. ("PRG"), Emmett E. Moore, M.D. ("Dr. Moore"), Richard M. Owen, and Richard J. D'Amico ("D'Amico") (collectively, the

"Individual Defendants"), and six PRG subsidiaries ("PRG subsidiaries"), alleging in relevant part that PRG and the Individual Defendants violated § 10(b) of the Securities Exchange Act of 1934 (the "Exchange [*3] Act"), *15 U.S.C. § 78j*(b), and Securities and Exchange Commission Rule 10b-5 ("Rule 10b-5"), 17 C.F.R. § 240.10b-5 (1998), promulgated thereunder. The Physicians contend the Individual Defendants are liable as controlling persons pursuant to § 20(a) of the Exchange Act, *15 U.S.C. § 78t*(a). n3

n1 As plaintiffs and defendants both recognize, *see* Ps. Br. at 1 n.1; Ds. Br. at 2 n.2, the professional association-plaintiffs do not assert federal securities law claims. Accordingly, as have the parties, the court uses the terms "plaintiffs" and the "Physicians" interchangeably.

n2 Plaintiffs are Robert Burlingame, M.D., Lawrence A. Shafron, M.D., John M. Haley, M.D., Shelby A. Wyll, M.D., and Rudolf Churner, M.D. On October 26, 1999 the court filed an agreed judgment dismissing the claims of Jeffrey Whitman, M.D. ("Dr. Whitman") and his professional association, JW Eye Associates, P.A. ("JW Eye"), against defendants Physicians Resource Group, Inc., Texas PRG VII, Inc., Emmett E. Moore, M.D., Richard M. Owen, and Richard J. D'Amico. Dr. Whitman and JW Eye are therefore no longer plaintiffs and their dismissed actions are not affected by today's decision. [*4]

n3 Although plaintiffs do not explicitly cite § 20(a), they otherwise plead that the Individual Defendants are liable as controlling persons. *See* Compl. P 102.

PRG is a publicly traded corporation that purports to specialize in providing management and administrative services to ophthalmologists and other professionals. n4 Before entering into the transactions at issue, the Physicians practiced ophthalmic medicine through individual practices that were organized as professional associations. Defendants induced each Physician to merge his practice into PRG, and to enter into a service agreement, in exchange for PRG stock and the provision of various services by PRG and a newly-created PRG subsidiary.

n4 The court recounts the facts as plaintiffs allege them in their second amended compliant. "Provided that plaintiffs plead specific facts, not conclusory allegations or unwarranted deductions of fact, the court accepts the allegations of their complaint as true and views them in the light most favorable to plaintiffs." *RGB Eye Assocs., P.A. v. Physicians Resource Group, Inc.*, Civil Action No. 3:98-CV-1715-D, slip op. at 1-2 (N.D. Tex. May 13, 1999) (Fitzwater, J.) (citing *Coates v. Heartland Wireless Communications, Inc., 26 F. Supp. 2d 910, 914, 915 (N.D. Tex. 1998)* (Fitzwater, J.)).

[*5]

To induce the Physicians to merge their practices with the PRG network, defendants n5 misrepresented PRG's existing abilities and infrastructure. They represented that PRG and the subsidiaries would assume exclusive managerial and administrative responsibility for all non-physician services, thereby allowing the Physicians to devote substantially all of their time to practicing medicine and providing patient services. PRG and the Individual Defendants also told the Physicians that the merger would make their practices more profitable because of economies of scale in accounting and management services that would reduce their administrative costs and dramatically reduce the resources required of their professional associations to maintain accounting and bookkeeping functions. PRG and the Individual Defendants also represented that PRG had the necessary systems and staff to take over the administrative and management functions of the Physicians' respective practices. Defendants told the Physicians that PRG had developed centralized patient billing and collections systems that could maintain the separate books of each individual practice. PRG and the Individual Defendants informed the [*6] Physicians that PRG was presently capable of providing substantial marketing assistance and help to increase the size of their respective practices; possessed special expertise in negotiating, establishing, and supervising managed care contracts with insurers, health maintenance organizations, and other health care providers; and had special expertise in recruiting new physicians, which would allow the Physicians to grow their practices.

n5 *See* discussion *infra* at § IV(C) concerning plaintiffs' use of the term "defendants" in their complaint.

A group of PRG representatives, including defendant Dr. Moore, knowingly misrepresented to certain of the Physicians that PRG's acquisition program was moving forward successfully and ahead of schedule; that PRG had the management expertise and experience, management information and accounting systems and controls, and personnel and expertise to perform the necessary due diligence on acquisitions to assure that PRG was acquiring only high quality, profitable practices [*7] that met its standards and that could be quickly integrated into PRG; and that PRG had successfully integrated the practices that it had acquired to date.

The PRG prospectus provided to each Physician misrepresented that PRG possessed adequate infrastructure and other capabilities to provide management and administrative support to the Physicians; the services that PRG was currently performing for its affiliated practices and PRG's then-current abilities; that PRG had the primary responsibility for the business and administrative aspects of the practices; that PRG had installed a client server-based information management system; and PRG's ability and desire to provide capital to help its practices expand and acquire new equipment.

In substantially identical transactions, the Physicians merged their medical practices and professional associations into newly-formed PRG subsidiaries, established new professional associations to receive all management and administrative services from the subsidiaries, and executed service agreements that obligated the subsidiaries to provide general administrative services such as billing, collections, accounting, purchasing operations, inventory planning, [*8] management information services, and other business functions. The subsidiaries became obligated to expand the Physicians' practices, such as by negotiating, establishing, and supervising managed care contracts with new and existing payor relationships, and by providing marketing and public relations assistance. In exchange for these services, the Physicians' professional associations paid 35% of their net profits to the subsidiaries and reimbursed them for all expenses. The physicians also received PRG common stock. Some shares were restricted (or at least contractually restricted) so that they could be sold only in compliance with the volume and holding period requirements prescribed by Rule 144 of the Securities Act of 1933.

Soon after the transactions were completed, the Physicians discovered that despite the representations of PRG and the Individual Defendants, PRG was ill-equipped to manage their practices. PRG and the subsidiaries failed to relieve the Physicians to the maximum extent possible of all accounting, purchasing, non-physician personnel services, and other business aspects of the Physicians' practices; incorrectly performed payroll obligations and later outsourced [*9] the payroll functions (charging plaintiffs for the costs incurred); improperly performed payroll accounting and disbursements, requiring plaintiffs to perform some or all these payroll functions; did not possess an adequate infrastructure with which to deliver non-physician services to the plaintiffs; lacked adequate systems and adequately trained staff to deliver the services that the service agreements required; failed to develop efficiencies or synergies that produced increases in plaintiffs' revenues, reductions in their costs, or increased profitability; required former employees of plaintiffs to work on other PRG projects, staff meetings, and data gathering that did not benefit plaintiffs; increased plaintiffs' overhead without a corresponding increase in revenues; failed to provide management information systems that they had promised; failed to track intercompany accounts and provide timely and accurate accounting reports; did not produce accurate financial statements and balance sheets on a timely basis or create centralized patient billing and collections for all practices; failed to provide basic human resource support, including administration of personnel matters, and [*10] to provide better health care benefits to plaintiffs' former employees; failed or refused to provide reasonably adequate managed care services contracts and to negotiate improved terms in existing contracts; failed to procure the number or type of contracts that PRG represented it would acquire; failed or refused to provide promised marketing, advertising, and public relations services; failed or refused to establish joint planning boards or provide any long-term planning; failed to assist plaintiffs in acquiring new practice groups and attracting new physicians; failed to provide finance, planning, inventory, and purchasing services; and failed to develop the PRG network. Instead, PRG and the subsidiaries provided, at substandard levels and drastically increased costs, administrative services that the Physicians formerly supplied through their own staffs, resulting in decreased revenues, increased costs, less net income, increased administrative burdens, inadequate reporting and accounting, and reduced stature and prestige.

In material part, the Physicians attempt to allege scienter in the following paragraphs of their second amended complaint ("complaint"):

The Defendants [*11] made the above

misrepresentations with the intent to defraud. In particular, the Defendants were conscious of the fact that the Physicians would be induced to enter into the transaction by representations regarding PRG's expertise in accounting, management information systems, and recruitment, among other areas. Despite this fact, the Defendants made these misrepresentations, knowing them to be false when made.

Compl. P 55.

Alternatively, the Defendants were severely reckless in making the representations that PRG had the expertise and capability to adequately provide accounting, management information systems, and recruitment expertise to the Physicians in light of the fact that the Defendants were aware that the Defendants had no such expertise, and that acquiring any such expertise in the future was speculative at best.
Id. P 56.

Additionally, the Defendants had the motive and opportunity to commit the above misrepresentations. PRG's acquisitions of practices required capital. By misrepresenting its abilities as a company to perform services for the Physicians and other practices, PRG accomplished two goals. First, by convincing the Physicians that **[*12]** PRG had the ability to perform services that it could not, the Defendants could convince the Physicians to accept PRG stock as consideration for the transaction instead of cash. This fact provided the Defendants with the motive and opportunity to make the above misrepresentations regarding PRG's then-existing abilities and infrastructure, thereby reducing the cost to Defendants of practice acquisitions, and in particular, the acquisition of the Physicians' former practices.

Id. P 57.

Second, as set forth below, one-half of the shares received by the Physicians were "restricted" shares, meaning they could not be sold under certain circumstances, including prior to the passage of a specified amount of time and under a specified trading volume for the PRG stocks. The Defendants misrepresented PRG's abilities to accomplish the Defendants' goal of convincing Plaintiffs to accept such restrictions on the PRG stock. The Defendants' desire to effectuate a structure for the transaction that included these restricted shares presented the Defendants with a motive to commit the misrepresentations.

Id. P 58.

Therefore, the Defendants could realize a concrete **[*13]** benefit from misrepresenting or failing to accurately disclose their ability to perform services for the Physicians by reducing or eliminating the cash required to compensate the Physicians for the transaction. By inflating the abilities of PRG through misrepresentation, the Physicians were induced to accept stock (one-half of which was "restricted") in lieu of cash payments. Defendants' misrepresentations thereby allowed them to realize a lower cost of capital in the transactions with the Physicians. By controlling the information shared with the Physicians and failing to disclose the material, adverse information regarding PRG to the Physicians, the Defendants had the means and likely prospect of achieving this concrete benefit for themselves.

Id. P 59.

B

In *RGB Eye Assocs., P.A. v. Physicians Resource Group, Inc.*, Civil Action No. 3:98-CV-1715-D (N.D. Tex. May 13, 1999) (Fitzwater, J.) ("*RGB I*"), the court granted defendants' motion to dismiss but permitted plaintiffs to replead. In relevant part, the court held that plaintiffs had failed adequately to plead scienter based on motive and opportunity to commit securities fraud. *Id.*, slip op. at 20-22. Plaintiffs' **[*14]** scienter argument appeared to rest on two components: PRG stood to gain financially by selling PRG stock; and PRG needed to maximize the price of its stock so that it could acquire other physicians' practices. *Id.* at 19. The court rejected the first basis because plaintiffs had not pleaded particular facts that gave rise to a strong inference that the defendant acted with the required state of mind. A desire to reap financial rewards was insufficient to permit the inference because, if it were,

> fraud could be inferred in a vast, undifferentiated array of financial transactions that occur daily in a capitalistic, entrepreneurial economy. Federal securities law does not permit so indiscriminate a deduction, in which it could be inferred that virtually everyone who sold stock that later dropped significantly in value must have acted fraudulently.

Id. at 20. The court declined to accept the second ground because a company's animus to inflate its stock price because it is expanding through acquisitions and is primarily paying for them with common stock is indistinguishable from a motive to inflate its stock price to ensure a successful public offering. *Id.* at **[*15]** 21

(citing *Coates v. Heartland Wireless Communications, Inc., 26 F. Supp. 2d 910, 919 (N.D. Tex. 1998)* (Fitzwater, J.) ("*Coates I*")).

Defendants now move to dismiss, contending in relevant part that plaintiffs have again failed adequately to plead scienter.

II

The Private Securities Litigation Reform Act of 1995 ("PSLRA"), *15 U.S.C. § 78u-4*, obligates a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4*(b)(2). To plead scienter in conformity with Fed. R. Civ. P. 9(b), a plaintiff "must set forth specific facts to support an inference of fraud." *Lovelace v. Software Spectrum Inc., 78 F.3d 1015, 1018 (5th Cir. 1996)* (citing *Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994)).* "'Courts have uniformly held inadequate a complaint's general averment of the defendant's "knowledge" of material falsity unless the complaint also sets forth specific facts that make it reasonable to believe that defendant knew that a statement was false or misleading.'" *Maldonado v. Dominguez, 137 F.3d 1, 9 (1st Cir. 1998)* **[*16]** (quoting *Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992)).* A plaintiff may not rely on boilerplate or conclusory allegations to satisfy its pleading obligations. *See Tuchman, 14 F.3d at 1067* (holding that plaintiff must plead specific facts, not conclusory allegations); *In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 (3d Cir. 1997)* (concluding that boilerplate and conclusory allegations will not suffice); *Gross v Summa Four, Inc., 93 F.3d 987, 991 (1st Cir. 1996)* (stating that Rule 9(b) sets demanding standard and general averments of defendant's knowledge are not enough); *Lovelace, 78 F.3d at 1018* (holding that it is insufficient merely to allege that defendant had fraudulent intent). The PSLRA pleading standard requires that the specific facts alleged in the complaint must give rise to a *strong inference* of fraudulent intent. *See 15 U.S.C. § 78u-4*(b)(2); *Burlington, 114 F.3d at 1418; Suna v. Bailey Corp., 107 F.3d 64, 68 (1st Cir. 1997); Chill v. General Elec. Co., 101 F 3d 263, 267 (2d Cir. 1996).* **[*17]** When a complaint fails to plead scienter in conformity with the PSLRA, dismissal is required. *Coates v. Heartland Wireless Communications, Inc., 55 F. Supp. 2d 628, 634 (N.D. Tex. 1999)* (Fitzwater, J.) ("*Coates II*") (citing *Lirette v. Shiva Corp., 27 F. Supp. 2d 268, 275 (D. Mass 1998)); 15 U.S.C. § 78u-4*(b)(3)(A).

III

A

The Physicians maintain that defendants acted consciously or severely recklessly because they made the misrepresentations at issue with intent to defraud. As factual support, they allege that defendants "were conscious of the fact that the Physicians would be induced to enter into the transaction by representations regarding PRG's expertise in accounting, management information systems, and recruitment, among other areas." Compl. P 55. Plaintiffs assert that defendants made the misrepresentations with knowledge that they were false or did so with severe recklessness. *Id.* PP 55, 56.

Defendants argue that plaintiffs have not satisfied the stringent standard for establishing fraudulent intent that applies to allegations of scienter based on conscious behavior. They challenge the assertion of severe **[*18]** recklessness in P 56, contending that it is at best self-serving and conclusory because, for example, plaintiffs do not plead facts concerning defendants' expertise or how it was lacking, or that defendants were aware that they lacked such expertise.

B

A plaintiff can plead scienter "by identifying circumstances that indicate conscious behavior on the part of the defendant, though the strength of the circumstantial allegations must be correspondingly greater." *Coates II, 55 F. Supp. 2d at 635* (quoting *Tuchman, 14 F.3d 1061 at 1068).* "Conscious behavior is a 'more stringent standard.'" *Id.* (quoting *Lovelace, 78 F.3d at 1019 n.3).* "To allege scienter based on conscious conduct, a plaintiff must plead strong circumstantial evidence of misbehavior." *55 F. Supp. 2d at 638* (citing *Burlington, 114 F.3d at 1418).*

Severe recklessness "is 'limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is **[*19]** so obvious that the defendant must have been aware of it.'" *Shushany v. Allwaste, Inc., 992 F.2d 517, 521 (5th Cir. 1993)* (quoting *Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981)* (en banc)). "A defendant's omissions or misrepresentations are severely reckless only if they (1) involve an extreme departure from the standards of ordinary care, and (2) present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Lovelace, 78*

F.3d at 1018 n.2. "The facts alleged to support recklessness must be 'strong circumstantial evidence' of that recklessness" and "must, in fact, approximate an actual intent to aid in the fraud being perpetrated." *Chill, 101 F.3d at 269* (quoting *Acito v. IMCERA Group, Inc., 47 F.3d 47, 52 (2d Cir. 1995)*, and *Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982)); see Maldonado, 137 F.3d at 9 & n.4* (holding that severe recklessness requires strong inference that defendant knew statement or omission was false or misleading). A plaintiff **[*20]** cannot rely on rote and conclusory allegations that a defendant acted recklessly. *Melder v. Morris, 27 F.3d 1097, 1103-04 (5th Cir. 1994).*

C

The problem with plaintiffs' efforts to transform a common law fraud or breach of contract lawsuit into a federal securities law case is underscored by the inadequacies in their scienter allegations. The securities component of plaintiffs' case--which is based on their accepting stock as part of the consideration for merging with the PRG network--must carry a load that the complaint will not support. This deficiency is initially revealed in the context of plaintiffs' efforts to plead scienter based on conscious behavior and severe recklessness. Both means of alleging scienter rest on the same facts. Plaintiffs assert their severe recklessness theory in the alternative. Compl. P 56. The court may therefore address them together. *See Coates II, 55 F. Supp 2d at 641* (adopting same reasoning in both contexts where severe recklessness allegations were virtually identical to conscious behavior assertions).

Plaintiffs allege that defendants misrepresented PRG's expertise in accounting, management information systems, **[*21]** and recruitment, among other areas to induce them "to enter into *the transaction." Id.* P 55 (emphasis added); *see id.* P 76 (alleging that "Plaintiffs were lured into the PRG system"); *id.* P 86 (alleging that "Plaintiffs [were] duped into entering the PRG network"). They allege no specific facts concerning defendants' intent to induce them by such representations to accept *the stock* in partial payment for their practices. Although plaintiffs purport to assert securities fraud, when their complaint is carefully read and considered in its entirety, it is apparent that plaintiffs do not attempt to allege that defendants made misrepresentations to induce them *to accept stock* in consideration for selling their practices. Instead, plaintiffs aver that to induce them to enter into *the transactions--i.e.*, sell their practices, execute the service agreements, and merge into the PRG network--defendants misrepresented that the Physicians' practices would achieve economies of scale, increased operational and administrative efficiencies, increased revenues through managed care contracts and services and additional patient referrals within the PRG network, reduced operating **[*22]** costs, and higher profits; the Physicians would obtain management and administrative services, office space, furniture, fixtures, inventory, equipment, and non-medical employees; the structure would eliminate the Physicians' need to oversee management, administrative, and business operations of their practices, thereby allowing them to devote substantially all of their time to practicing medicine and providing patient services; and that PRG and the subsidiaries would take over the administrative and management functions of the Physicians' practices, provide substantial marketing assistance and help plaintiffs increase the size of their respective practices, negotiate, establish, and supervise managed care contracts with insurers, health maintenance organizations, and other health care providers, and provide special expertise in the recruitment of new physicians, which would allow the Physicians to grow their practices.

Plaintiffs have failed to allege specific facts that support a strong inference of fraudulent intent based on conscious or severely reckless behavior because they have not even pleaded facts that explicitly relate to the stock component of the transaction. The court **[*23]** concludes that they have failed to plead scienter on this basis.

IV

A

The Physicians allege that defendants had the motive and opportunity to make the misrepresentations in question because PRG needed capital to acquire practices. By misrepresenting PRG's abilities to perform services for the Physicians and other practices, defendants could convince the Physicians to accept PRG stock for the transaction instead of cash. Defendants therefore had the motive and opportunity to misrepresent PRG's then-existing abilities and infrastructure, thereby reducing the cost of acquiring practices, particularly the Physicians' former practices. *Id.* P 57. Additionally, one-half of the shares that the Physicians received were restricted and could only be sold after a specific time period had elapsed and under a specified trading volume. The Physicians aver that defendants misrepresented PRG's abilities in order to accomplish defendants' goal of convincing plaintiffs to accept these restrictions on PRG stock. Defendants had the motive and opportunity to commit the misrepresentations because of their desire to effectuate a structure for the transaction that included

these restrictions. *Id.* **[*24]** P 58. Defendants could realize a concrete benefit from misrepresenting or failing accurately to disclose their ability to perform services for the Physicians by reducing or eliminating the cash required to compensate them. By inflating PRG's abilities, the Physicians were induced to accept stock (one-half of which was restricted) in lieu of cash. This permitted defendants to accomplish a lower cost of capital in the transaction. Defendants had the means and likely prospect of achieving this concrete benefit for themselves by controlling the information shared with the Physicians and failing to disclose material, adverse information concerning PRG. *Id.* P 59.

Defendants maintain that plaintiffs have attempted superficially to address *RGB I* and the stringent requirements of the PSLRA, and have done nothing more than "tweak their previous allegations" in an effort to plead facts that would bring them within *Cohen v. Koenig, 25 F.3d 1168 (2d Cir. 1994).* Defendants argue that plaintiffs' changes to their first amended complaint do not correct the deficiencies in that pleading because plaintiffs are still asserting as a motive defendants' alleged desire to maintain **[*25]** high stock prices for offerings or acquisitions, and are doing so based on conclusory assertions that fail to allege specifically a personal benefit that defendants could have realized. They contend that *Cohen* does not control in view of the subsequent enactment of the PSLRA. Defendants also posit that plaintiffs have failed to plead facts establishing motive and opportunity as to each defendant, and have instead addressed their scienter allegations to the "Defendants" generally, without offering detail concerning each one.

B

A plaintiff can plead scienter based on motive and opportunity. *Coates II, 55 F. Supp. 2d at 642.* "To plead motive, a plaintiff must aver with particularity the concrete benefits that could be recognized by a statement or omission." *Id.* (citing *Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994)).* "To plead opportunity, a plaintiff must allege specific facts that set out the means and likely prospect of achieving concrete benefits by the means alleged." *Id.*

C

The court agrees with defendants that the Physicians have failed to plead motive and opportunity scienter as to each defendant. In the scienter **[*26]** paragraphs of their complaint, plaintiffs allege that "Defendants" acted with intent to defraud. Compl. PP 55-59. Assuming *arguendo* that there are some circumstances in which multiple defendants in a federal securities lawsuit have the same or substantially identical motives so that scienter can be pleaded collectively, in the present case the term "Defendants" necessarily includes the six PRG subsidiaries that were created and then merged with the Physicians' practices. Under the facts as plaintiffs have alleged them, these entities could not have been in existence at the time the alleged misrepresentations were made. It is therefore nonsensical under plaintiffs' theory of the case to assert that not-yet-existent subsidiaries made misrepresentations to the Physicians. The complaint is further confused by the fact that in P 54, plaintiffs assert that they decided to enter into the transactions with PRG "based on representations that PRG and the Individual Defendants made," which would appear to exclude the subsidiaries. *Id.* P 54. Accordingly, the court holds that the complaint is deficient on this basis.

D

The court holds that the Physicians have not adequately pleaded motive **[*27]** based on defendants' desire to reduce practice acquisition costs by persuading physicians to accept stock in lieu of cash. Compl. P 57. First, this allegation is not supported by any particular facts. n6 Paragraph 47 of the complaint is illustrative. Plaintiffs contend in conclusory fashion that

PRG and the Individual Defendants made a number of representations to each of the Physicians concerning the PRG stock that would be issued to them if they decided to accept PRG's proposal and enter into the merger. Some of these were oral. Others were contained in PRG prospectuses that PRG and the Individual Defendants gave the Physicians.

Id. P 47. Nowhere in plaintiffs' 149-paragraph complaint do they allege any detailed facts to support the contention that defendants were motivated to commit fraud to reduce their costs of acquiring practices. Plaintiffs assert in their brief that "[a] substantial portion of the negotiations regarding PRG's 'purchase' of the Physicians' respective practices regarded the amount of stock--in lieu of cash--the Physicians would receive." Ps. Br. at 21-22 (footnote omitted). In support of this contention they cite PP 58 and 65-70 of their **[*28]** complaint. *Id.* at 22 n.14. These paragraphs merely plead the historical facts concerning the restricted nature of the shares and allege in conclusory fashion that defendants misrepresented PRG's abilities to convince plaintiffs to accept the stock restrictions.

n6 Plaintiffs maintain in their brief that their complaint is not conclusory. They argue:

> Without belaboring this point, the Physicians specify in detail the factual allegations upon which their claims are based. The Physicians provide specific instances that explain what was misrepresented by whom, and why these misrepresentations infer fraudulent intent.

Ps. Br. at 22. Plaintiffs do not support this contention with citations to any part of their complaint, and the court has located no such specifically pleaded facts to support the assertion of scienter.

Second, this rationale is akin to the scienter theory that the court rejected in *RGB I*--a desire by defendants to maximize PRG's stock price to allow it to expand through acquisitions. **[*29]**

Third, courts reject motive theories that would almost universally permit an inference of fraud. "Rule 9(b) jurisprudence, and now the PSLRA, seeks to eliminate as a predicate for a securities fraud claim allegations of motive that would effectively eliminate the state of mind requirement." *Coates II, 55 F. Supp. 2d at 644* (citing *Melder, 27 F.3d 1097 at 1102).* "Accordingly, assertions that would almost universally be true ... are inadequate of themselves to plead motive." *Id.* Such allegations are "alone insufficient to plead a strong inference of fraud." *Id.* (citing *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 805, 814 (2d Cir. 1996))* "This is particularly true where, as here, plaintiffs do not allege specific facts[.]" *Id.*

If the court approved the Physicians' attempt to allege scienter on this basis, it would effectively sanction the pleading of motive in any transaction, for example, in which a purchaser of businesses acquired one partly for stock and partly for cash. One could always infer that the purchaser had acted with intent to defraud because it was motivated to "preserve **[*30]** its capital." Even plaintiffs recognize in their brief that "with most transactions, the party receiving the consideration for its assets ... prefers cash, while the party making the purchase ... prefers non-cash consideration, if possible." Ps. Br. at 21. It is precisely for this reason--that such a motive would be present in "most transactions"--that plaintiffs' assertion is one "that would almost universally be true" and is therefore insufficient to plead motive. n7

n7 The court held in *RGB I* that plaintiffs had failed to "allege Cohen-type facts." *RGB I*, slip op. at 20. Assuming *arguendo* that they have now done so, the court declines to follow *Cohen* because it is a decision of another circuit, decided prior to enactment of the PSLRA on the basis of New York substantive law.

The Physicians next contend that defendants were motivated to commit fraud because one-half of the shares were restricted, and defendants misrepresented PRG's abilities in order to persuade the Physicians to accept **[*31]** restricted shares because it enabled defendants to realize a lower cost of capital. Compl PP 58, 59. Plaintiffs are alleging not only that defendants misrepresented the facts to induce them to accept stock in lieu of cash, but to accept *restricted* stock instead of cash (or, perhaps, in lieu of unrestricted stock). This assertion is not materially different from the one that the court has already held to be inadequate. First, as before, the allegation is conclusory and is not supported by specific facts. Second, it is analytically akin to a contention that a party sought to facilitate expansion by reducing costs. Third, if held to be adequate, it would permit an inference of fraud any time a company--in order to reduce its cost of capital--placed restrictions on the stock that it included as consideration for a purchase.

The court holds that plaintiffs have failed to plead a strong inference of fraud under a motive theory. n8

n8 Because the court holds that plaintiffs have failed to plead a motive to commit fraud, it need not consider whether plaintiffs have pleaded opportunity. *See Coates II, 55 F. Supp. 2d at 642 n. 21.*

[*32]

V

The Physicians seek to hold the Individual Defendants liable pursuant to § 20(a) of the Exchange Act, *15 U.S.C. § 78t*(a), as controlling persons. Because the court has dismissed the underlying securities law claims, the court holds that the Individual Defendants are not liable as controlling persons.

VI

Plaintiffs argue that the court should permit them to

replead in the event it grants defendants' motion. Ps. Br. at 23-24. The court disagrees. The court has already once held that plaintiffs have failed adequately to plead scienter, *see RGB I*, slip op. at 20-22, and they have had an opportunity to replead after the court granted a motion to dismiss. *Id.* at 23. The reasoning that the court follows today is not substantially based on constituent reasons that defendants failed to raise. *Cf. Coates II, 55 F. Supp. 2d at 633.* And the court is not persuaded, in view of the nature of this case, that plaintiffs can adequately plead scienter even if given a third opportunity to do so.

VII

Apart from plaintiffs' federal securities laws claims, the only other count that conceivably alleges a federal claim is count eight, in which plaintiffs **[*33]** seek a declaratory judgment that various transactional documents violate the Federal Anti-Kickback Statute, *42 U.S.C. § 1320a-7b*(b), *et seq. See* Compl. PP 132-134. n9 The Declaratory Judgment Act, however, does not confer subject matter jurisdiction on this court. *See Skelly Oil Co. v. Phillips Petroleum Co., 339 U.S. 667, 671, 94 L. Ed. 1194, 70 S. Ct. 876 (1950).* Even if it did, the Declaratory Judgments Act is "an authorization, not a command." *Public Affairs Assocs., Inc. v. Rickover, 369 U.S. 111, 112, 82 S. Ct. 580, 7 L. Ed. 2d 604 (1962).* Hence, federal district courts have broad discretion to grant or refuse declaratory relief. *See Brillhart v. Excess Ins. Co. of Am., 316 U.S. 491, 494, 86 L. Ed. 1620, 62 S. Ct. 1173 (1942)* (district court under no compulsion to exercise jurisdiction under the Declaratory Judgments Act); *Cornhill Ins. PLC v. Valsamis, Inc., 106 F.3d 80, 84 (5th Cir. 1997); Torch, Inc. v. LeBlanc, 947 F.2d 193, 194 (5th Cir. 1991).* The court declines to exercise jurisdiction over a declaratory judgment action that constitutes the lone federal count in what is otherwise a state-law **[*34]** lawsuit. The court dismisses count eight without prejudice.

n9 Although count eight clearly alleges a Declaratory Judgment action pursuant to *28 U.S.C. § 2201* rather than an action under *42 U.S.C. § 1320a-7b*(b), *et seq.*, plaintiffs assert in the jurisdictional allegation of their complaint that federal question jurisdiction is in part based on "the Federal Anti-Kickback Statute." Compl. P 24. The court disagrees. This statute imposes criminal penalties for certain unlawful acts. It does not expressly create a private right of action, and the court has located no authority that holds that it does. Accordingly, plaintiffs cannot invoke this court's original jurisdiction on this basis.

VIII

Having dismissed plaintiffs' federal claims, the court now dismisses their state-law claims without prejudice. As the court noted in *RGB I*, slip op. at 9 n.5, the court recognizes that it retains subject matter jurisdiction even if only state-law claims remain involving **[*35]** non-diverse parties. Because *28 U.S.C. § 1367*(c)(3) permits the court to dismiss state-law claims without prejudice when "the district court has dismissed all claims over which it has original jurisdiction," this court's virtually unflagging practice has been to dismiss such claims except where the federal causes of action drop out after extensive litigation and in close proximity to trial, in which case the parties would suffer palpable prejudice by starting over in state court. This lawsuit, which plaintiffs filed 15 months ago and, due to the presence of federal securities law claims, has not proceeded past the pleading stage, does not qualify for this highly unique category of cases. Accordingly, the court in its discretion dismisses plaintiffs' state-law claims without prejudice.

***Defendants' motion to dismiss is granted and the Physicians' claims under § 10(b) of the Exchange Act, Rule 10(b)-5, and § 20(a) of the Exchange Act are dismissed with prejudice. The balance of the case is dismissed without prejudice. The court has filed a judgment today. **[*36]**

SO ORDERED.

October 27, 1999.

SIDNEY A. FITZWATER

UNITED STATES DISTRICT JUDGE

United States District Court, N.D. Texas, Dallas Division.

Jeffrey SCHILLER, et al., On Behalf of Themselves and All Others Similarly Situated, Plaintiffs,
v.
PHYSICIANS RESOURCE GROUP, INC., et al., Defendants.

No. Civ.A. 3:97-CV-3158-L.

Feb. 26, 2002.

MEMORANDUM OPINION AND ORDER

LINDSAY, J.

*1 Before the court are the following five motions:
1. Physician Resource Group's Motion to Dismiss Third Amended Complaint, filed February 5, 2001;

2. Individual Defendants Emmett E. Moore, Richard M. Owen, and Richard J. D'Amico's Motion to Dismiss Plaintiff's Third Amended Complaint for Violations of the Securities Exchange Act of 1934, filed February 5, 2001;
3. Defendant John N. Bingham's Motion to Dismiss Plaintiff's Third Amended Complaint, filed February 6, 2001;
4. Defendant Arthur Andersen L.L.P.'s Motion to Dismiss Plaintiff's Third Amended Complaint, filed February 5, 2001; and,
5. Plaintiffs' Motion to Strike Tabs I, J, K, filed March 22, 2001. [FN1]

FN1. Plaintiffs move to strike three exhibits contained in Appendix A to Defendant PRG's Motion to Dismiss Third Amended Complaint, filed February 5, 2001. Tab I contains a chart that delineates certain of the alleged misrepresentations and omissions with corresponding cautionary language taken from PRG's prospectuses. Tab J contains another chart that lists the alleged misrepresentations and omissions placed adjacent to the reasons why they are insufficient as a matter of law. Finally, Tab K contains a chart that categorizes the alleged misrepresentations and omissions into a number of subcategories. Plaintiffs contend that PRG uses Tabs I, J, and K to extend the number of pages of briefing beyond the page limits imposed by the court's October 2000 briefing order. The court has not relied on any information or briefing contained in the aforementioned appendices. The court, therefore, denies as moot plaintiffs' motion to strike.

After careful consideration of the motions, responses, replies, and the applicable law, the court, for the reasons stated below, grants defendants' motions to dismiss.

I. Factual and Procedural Background

Plaintiffs are a class of persons who purchased or otherwise acquired Defendant Physician Resource Group Inc.'s ("PRG") common stock during the period between September 15, 1995 and November 19, 1997 (the "class period"). They sue PRG, Emmett E. Moore ("Moore"), Richard M. Owen ("Owen"), Richard J. D'Amico ("D'Amico"), and John N. Bingham ("Bingham") (collectively, the "Individual Defendants"). [FN2] Plaintiffs also sue Arthur Andersen L.L.P. ("Andersen"), PRG's independent auditor. Plaintiffs allege that PRG, the Individual Defendants, and Andersen violated § 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. The Plaintiffs further contend the Individual Defendants are liable as controlling persons pursuant to § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

FN2. During Class Period, Moore was Chief Executive Officer, President and Chairman of the Board of Directors; Owen was Chief Financial Officer and a director; D'Amico was Executive Vice President and Chief Administrative Officer; and Bingham was the Controller, Vice President, and Chief Accounting Officer. Plaintiffs' Third Amended Complaint [hereinafter "Third Am. Compl."] ¶ 21.

Defendant PRG is a publically traded corporation that acquired the assets of and provided management services to ophthalmic and optometric practices. PRG went public in June 1995, and over the following eighteen months, acquired more than 150 eye-care practices nationwide. In March 1996, PRG added nearly 70 individual eye-care practices with its acquisition of EyeCorp, Inc., and by October 1996, PRG had acquired its two primary competitors, American Ophthalmic and EquiMed.

PRG hoped to integrate these individual practices, and under common ownership, use its management expertise, increased capital, and improved information and accounting systems to achieve economies of scale, synergies of operation, and increased earnings per share. During this period of growth by acquisition, PRG stock reached a class period high of just under $35 a share.

Plaintiffs allege that between approximately September 1995 and February 1997, PRG and the Individual Defendants issued false and misleading statements concerning their management expertise, their ability to integrate the acquired practices, and the success of their management information and accounting systems. These statements, among others, were purportedly made to artificially inflate the stock price, thereby enabling PRG to acquire practices using a combination of cash and stock as currency. Plaintiffs allege this "scheme" enabled PRG to acquire practices with fewer shares, maintain an appearance of profitability, and later market itself as an attractive acquisition candidate. During the class period, PRG and the Individual Defendants described the Company in press releases and other publically filed documents as a "preeminent leader," which had "successfully integrated" a number of practices, and was "ready to move forward with the future integration" of others. PRG and the Individual Defendants also asserted they had a "strong," "deep management team" that was able to integrate their acquisitions with "sophisticated management information systems" and "strong internal monitoring and controls."

***2** Plaintiffs claim that contrary to these statements, PRG lacked the management information and accounting systems necessary to manage its existing businesses and integrate the acquired practices. Plaintiffs also allege that PRG failed to conduct adequate due diligence before acquiring several of the eye-care practices, which resulted in the acquisition of practices with diminishing bottom lines, poor financial structures, and other legal liabilities. Plaintiffs maintain that Andersen participated in this "scheme" by issuing unqualified audit reports on PRG's financial statements for the years ending December 31, 1995 and December 31, 1996, and by reviewing year 1997 quarterly reports. In short, Plaintiffs charge that PRG, the Individual Defendants, and Andersen concealed the true financial condition of the corporation, failed to disclose material, adverse facts about its operations and finances, and used misrepresentations to make misleading forecasts about its earnings and growth potential.

Plaintiffs further base claims on representations contained in those financial statements filed with the SEC for the fourth quarter of 1995, all of 1996, and the first and second quarters of 1997. These representations were false and misleading, Plaintiffs allege, because the financial information contained therein was not prepared in conformity with GAAP and relevant SEC regulations. Specifically, Plaintiffs claim that Defendants overstated revenues, belatedly booked certain charges, and failed to establish adequate reserves for uncollectible receivables. Plaintiffs further allege that Defendants overstated the assets acquired in the EquiMed acquisition, forcing them to incur a one time $31.75 million "asset valuation loss" in the third quarter of 1997. These revelations, among others, led to the eventual termination of Moore and Owen, and according to Plaintiffs, caused the price of the stock to fall more than ninety-three percent from its class period high.

Plaintiffs filed suit against PRG and the Individual Defendants in December 1997. Plaintiffs amended their complaint against PRG and several of the Individual Defendants in July 1998. In November 1998, Plaintiffs filed a separate action against Andersen, which was transferred to this court in December 1998, and consolidated with Plaintiffs' initial action on October 4, 2001. In June 1999, Plaintiffs again amended their complaint, adding Andersen as a defendant, and amending their previous claims against PRG and the several of the Individual Defendants. Plaintiffs' Third Amended Complaint was filed on December 21, 2000. Defendants, collectively, now move to dismiss Plaintiffs' Third Amended Complaint for failure to state a claim under Fed.R.Civ.P. 12(b)(6), for failure to plead fraud with particularity pursuant to Fed.R.Civ.P. 9(b), and for failure to plead scienter as required by the Private Securities Litigation Reform Act of 1995 ("PSLRA").

II. Applicable Pleading Standards

A. Pleading Requirements of Rules 12(b)(6), 9(b) and the PSLRA

***3** A motion to dismiss for failure to state a claim

under Fed.R.Civ.P. 12(b)(6) "is viewed with disfavor and is rarely granted." *Lowrey v. Texas A & M Univ. Sys.*, 117 F.3d 242, 247 (5th Cir.1997). A district court must not dismiss a complaint, or any part of it, for failure to state a claim upon which relief can be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Coates v. Heartland Wireless Communications, Inc.*, 26 F.Supp.2d 910, 913-14 (N.D.Tex.1998) (*"Coates I"*). The court must accept all well-pleaded facts in the complaint as true and view them in the light most favorable to the plaintiff. *Baker v. Putnal*, 75 F.3d 190, 196 (5th Cir.1996). The plaintiff, however, must plead specific facts; the court will not accept conclusory allegations in the complaint as true. *Kaiser Aluminum & Chem. Sales, Inc. v. Avondale Shipyards*, 677 F.2d 1045, 1050 (5th Cir.1982); *Robertson v. Strassner*, 32 F.Supp.2d 443, 445 (S.D.Tex.1998); *Zuckerman v. Foxmeyer Health Corp.*, 4 F.Supp.2d 618, 621 (N.D.Tex.1998).

Plaintiffs assert a claim pursuant to the Section 10(b) of the Securities and Exchange Act, 15 U.S.C. 78j, as amended by the PSLRA. Section 10(b) makes it unlawful for a person to:

> use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). In relevant part, Rule 10b-5 makes it unlawful for any person, directly or indirectly, to:

> make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

To state a claim under these provisions, a plaintiff must allege (1) a misrepresentation or omission; (2) of a material fact; (3) made with the intent to defraud; (4) on which the plaintiff relies; (5) which proximately caused the plaintiff's injury. *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177 (5th Cir.1997); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir.1994); *Cyrak v. Lemon*, 919 F.2d 320, 325 (5th Cir.1990). Where a plaintiff alleges "a fraud on the market" theory, it is not necessary for the plaintiff to prove individual reliance on the false or misleading statement. *Nathenson v. Zonagen, Inc.*, 267 F .3d 400, 414 (5th Cir.2001); *Coates I*, 26 F.Supp.2d at 914 n. 1; *Zuckerman*, 4 F.Supp.2d at 621. Instead, a plaintiff may show that he indirectly relied on the statements by relying on the integrity of the market price of the stock. *Nathenson*, 267 F.3d at 414.

***4** Because section 10(b) claims sound in fraud, the plaintiff must also satisfy the pleading requirements imposed by Fed.R.Civ.P. 9(b). *Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir.1994); *Tuchman*, 14 F.3d at 1067. Rule 9(b) requires certain minimum allegations in a securities fraud case, namely, the specific time, place, and contents of the false representations, along with the identity of the person making the false representations and what the person obtained thereby. *Melder*, 27 F.3d at 1100; *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 521 (5th Cir.1993). This application of the heightened pleading standard provides defendants with fair notice of the plaintiff's claims, protects them from harm to their reputations and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims and then attempting to discover unknown wrongs. *Melder*, 27 F.3d at 1100; *Tuchman*, 14 F.3d at 1067.

The PSLRA further reinforces the particularity requirement. *Coates I*, 26 F.Supp.2d at 914. The PSLRA requires that

> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). To satisfy Rule 9(b) and the PSLRA, a plaintiff must plead facts and avoid reliance on conclusory allegations. *Tuchman*, 14 F.3d at 1067; *Coates I*, 26 F.Supp.2d at 915. The PSLRA further requires that any allegations made on information and belief must state with particularity all facts on which that belief is formed. *Robertson*, 32 F.Supp.2d at 446; *Coates I*, 26 F.Supp.2d at 915.

B. Scienter Requirement

In addition to the aforementioned pleading requirements, plaintiffs asserting securities fraud claims must allege facts demonstrating scienter. *Lovelace,* 78 F.3d at 1018; *Tuchman,* 14 F.3d at 1068; *Zuckerman,* 4 F.Supp.2d at 622. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud ." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976); *Lovelace,* 78 F.3d at 1018. Allegations of recklessness may satisfy the scienter requirement, however, such occasions are limited to "severe recklessness," which "resembles a slightly lesser species of intentional misconduct." *Nathenson,* 267 F.3d at 408. The Fifth Circuit defines "severe recklessness" as

> limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."
> *Id.*

The PSLRA also requires that the "complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). When such facts are based on information and belief, the PSLRA requires that the complaint state with particularity all facts on which that belief is informed. 15 U.S.C. § 78u-4(b)(1).

III. Analysis

***5** Defendants move to dismiss plaintiffs' complaint, contending it fails to satisfy the particularity requirements of Rule 9(b) and the PSLRA, and because Plaintiffs have not adequately pleaded facts raising a strong inference of scienter. These arguments are examined below.

A. Particularity

Plaintiffs' Third Amended Complaint, which spans sixty-seven pages, represents a labyrinth, requiring the court to piece together the elements of the claims from allegations made all over the complaint. [FN3] The purported misrepresentations and omissions are broadly organized into four sections arranged in chronological order: The first section encompasses statements made by PRG and the Individual Defendants between September 18, 1995 and November 12, 1996, Third Am. Compl. ¶¶ 29-62; the second section encompasses those statements made between November 14, 1996 and February 11, 1997, *id.* ¶¶ 64- 79; the third section includes statements made between February 12, 1997 and September 4, 1997, *id.* ¶¶ 81-88; and, the fourth section identifies a series of purportedly false financial statements made in publically filed documents, *id.* ¶¶ 98, 100, 110-112. In each of these aforementioned paragraphs, the complaint identifies the alleged statement or omission, pleads the time, place, and content of the false representation, and in some cases, attempts to identify the speaker. The complaint contains no fewer than 56 purported misrepresentations.

> FN3. For example, rather than identify a false statement or omission and match it with specific facts explaining how the statement is misleading, Plaintiff's Complaint catalogs scores of purportedly false statements culled from press releases and other public information. The complaint reserves explanation regarding how or why the statements are misleading for several paragraphs interspersed throughout its sixty-seven pages. *See, e.g.,* Third Am. Compl. ¶¶ 63, 80, 82, 89. Moreover, nowhere does the complaint distinguish those facts relevant to Defendants' state of mind from those facts relevant to whether a misrepresentation is misleading. The court finds the complaint redundant and confusing. The organization of the complaint, or the lack thereof, makes it substantially more difficult for the court to assess the sufficiency of the complaint under Rule 9(b) and the PSLRA.

The court holds that Plaintiffs have failed to satisfy Rule 9(b) with respect to all purported misrepresentations or omissions that rely on "group pleading." Rule 9(b) requires Plaintiffs to "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *Williams,* 112 F.3d at 177-78. Before the adoption of the PSLRA, the "group pleading" doctrine created the presumption that the senior executives of a corporation may be held personally liable for misrepresentations or omissions contained

in public statements attributed to or issued by the corporation. *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F.Supp. 746, 759 (N.D.Cal.1997). Although there exists some debate in the district courts whether or not the group pleading doctrine survived the enactment of the PSLRA, this district has come to the resounding conclusion that it does not. *See Coates I,* 26 F.Supp.2d at 916 ("The PSLRA codifies a ban on group pleading.") (Fitzwater, J.); *Zishka v. American Pad & Paper Co.*, No. 3:98-CV-0660-M, 2000 WL 1310529, at *1 (N.D.Tex. Sept. 13, 2000) ("[T]his Court rejects the notion of 'group pleading,' and 'group publication' and concludes that such concepts ... did not survive the adoption of the PSLRA.") (Lynn, J.); *Lemmer v. Nu-Kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 WL 1112577, at *7 (N.D.Tex. Sept. 6, 2001) ("The group pleading doctrine is inconsistent with the particularity requirements of the PSLRA....") (Lindsay, J.); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, No. 4:00-CV-355-Y, slip op. at 6 (N.D.Tex. March 12, 2001) ("The Court initially finds that Plaintiffs' complaint fails because of its reliance on group pleading.") (Means, J.); *Calliot v. HFS, Inc.*, No. 3:97-CV-09241-I, 2000 WL 351753, at * 5 (N.D.Tex. March 31, 2000) (dismissing complaint based, in part, on plaintiffs' use of group pleading) (Lindsay, J.); *Branca v. Paymentech, Inc.*, No. 3:97-CV-2507-L, 2000 WL 145083, at *8 (N.D.Tex. Feb. 8, 2000) (same) (Lindsay, J.). Thus, the PSLRA requires plaintiffs to "distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud." *In re Silicon Graphics, Inc.*, 970 F.Supp.2d at 752 (emphasis added).

***6** With few exceptions, the complaint is replete with instances of such group pleading. For example, the complaint repeatedly asserts that Moore, D'Amico, Owen, and Bingham: "reviewed and approved" misleading reports issued by securities analysts, [FN4] disseminated false information during healthcare-conference presentations and road-shows, [FN5] issued false statements during conference calls to shareholders, analysts, money managers, and others, [FN6] and that Owen and Bingham signed the Form 10-Q's filed with the SEC. [FN7] Plaintiffs fail to identify any statements or omissions attributable specifically to either D'Amico or Owen, and in thirty-one references to Bingham, none contains any statements attributable to him apart from a group of individuals. The PSLRA and Rule 9(b) require Plaintiffs to identify the particular individual who made the misstatement or omission. Plaintiffs cannot avoid the bar on group pleading by simply identifying the constituents of a group of defendants in rote and conclusory fashion. Plaintiffs cannot satisfy Rule 9(b) by attributing statements or omissions to the corporation without any identification of the officer or director responsible for making the statement. [FN8] *See Coates v. Heartland Wireless Communications, Inc.* 55 F.Supp.2d 628, 633 n. 3 (N.D.Tex.1999) (*"Coates II"*) (finding statements attributed solely to corporation insufficiently particular under Rule 9(b) and the PSLRA).

FN4. *See, e.g.*, Third Am. Compl. ¶¶ 35, 35, 39, 46, 48, 50, 54, 55, 56, 59, 61, 62, 68, 69, 70, 72, 73, 76, 77, 79.

FN5. *Id.* ¶¶ 30, 31, 43, 57, 78.

FN6. *Id.* ¶¶ 37, 52, 66.

FN7. *Id.* ¶ 100.

FN8. *See, e.g., id.* ¶¶ 28, 41, 42, 44, 60, 81, 83, 85, 88.

The court thus concludes that Plaintiffs have failed to satisfy the heightened pleading requirements of Rule 9(b) and the PSLRA with respect to statements or omissions contained in the Third Am. Compl. ¶¶ 28, 30, 31, 34, 35, 37, 38, 39, 41, 42, 43, 44, 46, 48, 50, 52, 54, 55, 56, 57, 59, 60, 61, 62, 66, 68, 69, 70, 72, 73, 76, 77, 78, 79, 81, 83, 85, 88, 100.

B. Scienter

The PSLRA states that a securities fraud complaint "shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that defendants acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Plaintiffs must "set forth specific facts to support an inference of fraud." *Lovelace,* 78 F.3d at 1018. "A plaintiff may not rely on boilerplate or conclusory allegations to satisfy its pleading obligations." *Coates II,* 55 F.Supp.2d at 633. These facts, when "assumed to be true" must "constitute persuasive, effective, and cogent evidence from which it can logically be deduced that defendants acted with intent to deceive, manipulate, or

defraud." *Coates v. Heartland Wireless Communications, Inc.*, 100 F.Supp.2d 417, 422 (N.D.Tex.2000) (*"Coates III"*). "A mere reasonable inference is insufficient to survive a motion to dismiss." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir.1999). The Fifth Circuit, in *Nathenson,* recently clarified what "patterns of facts ... may be pleaded in order to create the 'strong inference' of either intentional misconduct or severe recklessness." 267 F.3d at 409. Before *Nathenson,* there existed some uncertainty in this circuit whether the motive and opportunity test for establishing scienter survived the passage of the PSLRA. *See id.* at 410. After an exhaustive analysis of the pleading requirements in various other circuits, and a review of the PSLRA's legislative history, the Fifth Circuit determined that

> *7 [w]hat must be alleged is not motive and opportunity as such but particularized facts giving rise to a strong inference of scienter. Appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter, but it would seem to be a rare set of circumstances indeed where those allegations alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength....

Id. at 412. Thus, the district court may consider evidence demonstrating a defendant's motive and opportunity to commit fraud so long as the totality of the allegations raises a strong inference of fraudulent intent. *Nathenson,* 267 F.3d at 411-412. When a complaint fails to plead scienter in conformity with the PSLRA, dismissal is required. 15 U.S.C. 78u-4(b)(3)(A); *Coates II,* 55 F.Supp.2d at 634.

1. Motive and Opportunity

a. Allegations Related to the Use of Stock as Currency

Plaintiffs' scienter theory rests primarily on the PRG and the Individual Defendants' purported motivation to maximize PRG's stock price to complete a large number of acquisitions. Only by completing acquisitions, Plaintiffs contend, could PRG meet earnings and growth expectations. Plaintiffs articulate this theory in ¶ 26 under the heading "PRG's and Individual Defendants' Motive for Participation in the Wrongful Course of Conduct":

> The Company and its top officers had strong motives to inflate the stock price. They wanted to pursue an accelerated acquisition program, because growth by acquisition provided the only way that they could foster the perception in the business community that PRG was a "growth" company, thereby ensuring a substantially inflated stock price. Because the Company did not have the cash necessary to pay for the acquisitions that the Individual Defendants wanted to make, PRG had to pay for them by issuing or selling stock or securities related to its stock to raise cash to pay for part of the acquisition prices. A high stock price was also important to the Individual Defendants because a material part of their net worth consisted of PRG's stock and the Company needed to maintain the appearance that it was profitable.

Third Am. Compl. ¶ 26. Judge Fitzwater twice rejected this scienter theory in a case involving PRG and several of the same individual defendants. *See RGB Eye Assocs., P.A. v. Physicians Resource Group, Inc.*, No. 3:98-CV-1715-D, slip op. (N.D. Tex May 13, 1999) (*"RGB I"*); *RGB Eye Assocs., P.A. v. Physicians Resource Group, Inc.*, No. 3:98-CV-1715-D, 1999 WL 980801 (N.D.Tex. Oct. 27, 1999) (*"RGB II"*). In *RGB I,* the court held that a "company's animus to inflate its stock price because it is expanding through acquisitions and is primarily paying for them with common stock is indistinguishable from a motive to inflate its stock price to ensure a successful public offering." *RGB II,* 1999 WL 980801 at *3. This does not create a strong inference of fraud because, if held to be adequate, it "would almost universally permit an inference of fraud." *Id.* at *9; *See also Mortensen v. AmeriCredit Corp.*, 123 F.Supp.2d 1018, 1023 (N.D.Tex.2000) ("[A]ssertions that would almost universally be true, such as the desire to raise capital, or successfully bring a public offering to fruition, economic self-interest, and the desire to maintain good relationships with suppliers, encourage retailers, forestall lenders, and protect one's executive position, are inadequate of themselves to plead motive.") (citations omitted).

***8** Plaintiffs contend the amended complaint in this case differs from the *RBG* complaints in two relevant respects. First, Plaintiffs claim the present complaint, unlike the complaint in *RGB I* or *RGB II,* details each of the specific acquisitions made during the class period that used stock as currency. *See* ¶ 15, 29, 58. These allegations, according to Plaintiffs, plead with particularity the dates, number

of shares, and the reasons behind each of the transactions. While the court agrees that the present complaint may satisfy Rule 9(b) in this regard, the court nevertheless finds Plaintiffs' motive theory unpersuasive. The court in *RGB I* and *RGB II* held that such generalized or universal allegations of motive are insufficient to establish scienter as a matter of law. This court agrees. In other words, Plaintiffs' motive theory does not fail for lack of particularity, but because in any transaction involving a combination of stock and cash, "[o]ne could always infer that the purchaser had acted with intent to 'preserve its capital." ' *RGB II,* 1999 WL 980801, at *9.

Second, Plaintiffs claim that the present complaint, unlike the complaint in *RGB II,* alleges a stronger form motive. Plaintiffs argue that PRG's very existence was premised on a "growth by acquisition" business model. This fact, they suggest, adds weight to their motive theory because the entire business would fail should PRG and the Individual Defendants be unable to complete a large, and presumably never-ending set of acquisitions. These allegations do not bolster or give any added weight to Plaintiffs' motive theory. Instead, the court finds Plaintiffs' theory circular and confusing. Under Plaintiffs' theory, the defendants artificially inflated the stock price to complete acquisitions, but found they must complete acquisitions, many of them without engaging in due diligence, solely to inflate the stock price and increase earning and growth. However characterized, Plaintiffs' motive theory boils down to one already rejected in both *RGB I* and *II,* namely, that the defendants sought to cheapen the cost of expansion by using a mix of cash and stock as currency.

Accordingly, the court holds that Plaintiffs' first motive theory does not meaningfully enhance any strong inference of scienter.

b. Allegations Related to Defendants' Wealth

Plaintiffs also allege as motive that Defendants inflated the stock price "because a material part of their net worth consisted of PRG stock." Third Am. Compl. ¶ 26. "To plead motive, a plaintiff must aver with particularity the concrete benefits that could be recognized by a statement or omission." *Coates II,* 55 F.Supp.2d at 642 (citations omitted). Allegations regarding compensation, without more, do not sufficiently plead a motive to commit securities fraud. *See Melder,* 27 F.3d at 1103; *Tuchman,* 14 F.3d at 1068 (finding no inference of scienter based on personal compensation where Plaintiffs did not aver that Defendants sold or purchased stock during the class period); *Nathenson,* 267 F.3d at 420 ("[A]llegations that corporate officers and directors would benefit from enhancing the value of their stock ... are likewise insufficient to support a strong inference of scienter."). Here, Plaintiffs do not allege that Defendants purchased, sold, or engaged in any other improper stock transaction during the class period. Absent any allegation that Defendants acted in their own self-interest to obtain concrete benefits, the court finds no inference of scienter. *See Melder,* 27 F.3d at 1102 (finding no "readily apparent" motive to commit securities fraud where complaint contains no allegation corporate defendants profited from inflated stock values).

***9** Accordingly, the court concludes that Plaintiffs have failed to plead a strong inference of fraud based on personal gain.

c. Allegations Related to Andersen's Motive

Plaintiffs allege that Andersen was primarily motivated to engage in securities fraud because it feared the public would learn that the consulting services it allegedly performed with respect to PRG's management information and accounting systems had failed. Ps. Br. at 23. This motive is by no means clear from the face of the complaint. Under the heading "Arthur Andersen's Motive for Participation in the Wrongful Course of Conduct," paragraph 27 states

> Arthur Andersen was motivated ... by its desire to retain PRG as a client, to continue to generate the substantial fees from its audit and review engagements, and to secure additional business from the Company including the more profitable consulting business. The partners responsible for the PRG engagement were particularly motivated to participate in the wrongdoing alleged because their incomes were directly tied to the fees generated from the engagement.... It also wanted to maintain and increase its market share for auditing, accounting, and consulting services in Texas and also in the managed care industry.

Third Am. Compl. ¶ 27. It is not until paragraphs 118 and 121(c) do Plaintiffs allege that Andersen

"set up PRG's initial MIS and consulted extensively on its information systems." Third Am. Compl. ¶ 118; *see also* ¶ 121(c) ("Because [Andersen] had designed PRG's MIS and continued to consult with the Company about the system, the auditors were very familiar with its weaknesses."). As pled, Plaintiffs fail to provide particularized facts that support this theory. Absent the conclusory allegation that Andersen set up PRG's initial management information systems, Plaintiffs plead no other facts that indicate what services and systems Andersen provided to the company, the level of Andersen's involvement after it had "initially" set them up, when these initial systems were activated, or how Andersen became aware of the systems' failure. Further, Plaintiffs ask the court to assume that these management and accounting systems did in fact fail, a proposition that, as the court explains below, is not itself pleaded with sufficient particularity to support a strong inference of fraud.

Plaintiffs' remaining allegations concerning Andersen's purported motive do not meaningfully enhance any inference of fraud. In *Melder,* the Fifth Circuit rejected similar motive allegations even before the adoption of the PSLRA. 27 F.3d at 1103 (finding insufficient as motive for securities fraud allegations that accounting firm sought to "protect and enhance fees," "maintain and increase its market share," "increase the income received" by firm partners, and "maintain its competitive position" among other accounting firms). Plaintiffs' remaining motive theories are the same type of boilerplate, generic allegations that the *Melder* Court found insufficient, and that could be alleged against any accounting firm engaged in the audit and consulting business. Accordingly, the court does not find that Plaintiffs' motive theory with respect to Andersen meaningfully enhances an inference of fraud.

2. Conscious or Severely Reckless Behavior

***10** Absent an apparent motive to commit fraud, "a plaintiff can plead scienter 'by identifying circumstances that indicate conscious behavior on part of the defendant, though the strength of the circumstantial evidence must be correspondingly greater" ' *Coates II,* 55 F.Supp.2d at 635 (quoting *Tuchman,* 14 F.3d at 1068). The conscious behavior standard is more stringent, and requires a strong inference that defendant knew the statement or omission was false or misleading when made. *See Coates III,* 100 F.Supp.2d at 424.

A Plaintiff may also plead scienter based on severe recklessness. "A Defendant's omissions or misrepresentations are severely reckless only if they (1) involve an extreme departure from the standards of ordinary care, and (2) present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Lovelace,* 78 F.3d at 1018 n. 2. When basing scienter on severe recklessness, the facts must present "strong circumstantial evidence of that recklessness and must, in fact, approximate an actual intent to aid in the fraud being perpetrated." *Coates III,* 100 F.Supp.2d at 424 (internal citations omitted); *see also Greebel,* 194 F.3d at 199 (noting that recklessness is closer to a lesser form of intent). Plaintiffs may not rely on rote conclusory allegations that Defendant "knowingly" or "recklessly" did something, but must instead plead with particularity facts that indicate Defendants either knew, or recklessly disregarded, information that should have been disclosed to the investing public. *Melder,* 27 F.3d at 1104.

Plaintiffs may not rely on fraud by hindsight to establish a claim for securities fraud. *See, e.g., Denny v. Barber,* 576 F.2d 465, 470 (2d Cir.1978). "Mere allegations that statements in one report should have been made in earlier reports do not make out a claim for securities fraud." *Coates III,* 100 F.Supp.2d at 429 (quoting *Stevelman v. Alias Research Inc.,* 174 F.3d 79, 84 (2d Cir.1999). A plaintiff must plead facts demonstrating that the statements or omissions alleged were fraudulent when made. *Thornton v. Micrografx, Inc.,* 878 F.Supp.2d 931, 934 (N.D.Tex.1995). Plaintiffs may not "scize upon disclosures in later reports and allege they should have been made in earlier ones." *Calliot,* 2000 WL 351753, at *8.

Plaintiffs allege that the Individual Defendants had access to internal corporate data and other non-public information that contradicted their public statements about the success of PRG's business and acquisition strategy. [FN9] A review of the complaint shows that Plaintiffs attempt to plead scienter based on the following alleged facts, statements, and omissions: (1) that PRG and the Individual Defendants failed to conduct adequate due diligence before making acquisitions; (2) that

contrary to PRG's purported "sophisticated" MIS and "strong operational and financial controls," the Individual Defendants and PRG failed to monitor existing operations; and, (3) that in order to overstate revenues, net income, and EPS, the Individual Defendants caused PRG to violate GAAP and SEC regulations. [FN10]

FN9. *See* Third Am. Compl. ¶ 21. As explained elsewhere, "if an allegation regarding [a] statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). In *Coates I,* the court noted that an "unsupported general claim of the existence of confidential company reports is insufficient to survive a motion to dismiss." 26 F.Supp.2d at 920. The court further noted that to support an inference of fraud, Plaintiffs must "provide more details about the alleged negative internal reports, such as the report titles, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information." *Id.* at 92.
In this case, Plaintiffs fail to provide any facts that support its information and belief allegation that the Individual Defendants had access to any such internal information. The complaint fails to identify what type of information they had access to, if any, the contents of such unnamed documents, or even which of the several individual defendants were in possession of this information. Accordingly, to the extent that Plaintiffs attempt to plead scienter on information and belief based on "internal corporate documents" or other "non-public information," the court holds that such allegations, without more, are insufficient under the heightened pleading standard of Rule 9(b) and the PSLRA, and thus cannot support a strong inference of fraud.

FN10. Plaintiffs' allegations regarding scienter further demonstrate the tension between the group pleading doctrine and the PSLRA. The complaint fails to plead scienter with respect to any of the defendants individually. The complaint also fails to identify any corporate agent when attempting to attach scienter to PRG alone. Instead, Plaintiffs make allegations regarding the Defendants' collective state of mind. In paragraphs 63, 80 and 82, for example, Plaintiffs generally aver scienter with respect to PRG or the Individual Defendants as a group. *See, e.g.*, Third Am. Compl. ¶ 63 ("The positive statements made by defendants ... were each known to be or were recklessly disregarded by them as false and misleading when made."); ¶ 63(a) ("PRG and the Individual Defendants ... knew or recklessly disregarded ..." EquiMed's overstated assets); ¶ 63(p) ("the Individual Defendants knew that the process of integrating ... would take much longer ..."); ¶ 80(a) ("PRG did virtually no due diligence."); ¶ 82 ("Individual Defendants knew of, but did not disclose, the negative effect of the EquiMed acquisition on revenue and operations."). These allegations do not support a strong inference of fraud because they do not plead scienter with regard to any Individual Defendant or corporate officer. The court might find plaintiffs' scienter allegations deficient on this basis alone. *See Coates I,* 26 F.Supp.2d at 916-17 ("Plaintiffs must properly plead wrongdoing and scienter as to each individual defendant and cannot merely rely on the individuals' positions or committee memberships within [the company]."). In an abundance of caution, and because several of the alleged misrepresentations or omissions are attributed to Moore alone, the court will examine each of the theories that Plaintiffs claim support an inference of scienter.

a. Allegations Related to Due Diligence

***11** Plaintiffs first allege that PRG and the Individual Defendants failed to engage in adequate due diligence before making the EquiMed acquisition. Paragraph 63(a) alleges

> Contrary to their representations ... PRG did virtually no due diligence before making acquisitions. For EquiMed, it never obtained separate, accurate, and complete financial statements of Equivision ... before completing the acquisition. Moreover, no inquiries were done by the Company in connection with any of the EquiMed New York state practice groups that were acquired. PRG and defendants knew or recklessly disregarded that revenues from the acquired EquiMed practice groups would decline because New York state does not allow fees to be split with non-doctors nor can corporations practice medicine.... PRG did not even obtain EquiMed's financials before making the $54-million cash acquisition.

Third Am. Compl. ¶ 63(a). These allegations do not create a strong inference of fraud. First, Plaintiffs do not state with sufficient particularity what due diligence PRG and the Individual

Defendants engaged in prior to the EquiMed acquisition, or for that matter, any other acquisition made during the class period. Nowhere do plaintiffs provide any specific facts that allege the level of due diligence accomplished on other acquisitions, which other acquisitions were completed without adequate due diligence, or which of the Individual Defendants participated or otherwise involved themselves in the due diligence process. Instead, Plaintiffs make the conclusory allegations that PRG did "virtually no due diligence" before completing this, and perhaps other, acquisitions. The court cannot find, based on these allegations, that defendants' conduct in connection with the due diligence process constitutes an extreme departure from the standards of ordinary care. The court refuses to make the inferential leap required to transform the allegation that PRG did *"virtually* no due diligence" (emphasis added) into a factual allegation that PRG *did no due diligence at all.* Finally, even assuming that such facts were pled with specificity, the failure to engage in due diligence before closing an acquisition does not automatically support an inference of fraud. *See, e.g., Brogen v. Pohlad,* 933 F.Supp. 793, 799 (D.Minn.1995) (failing "to adequately investigate the merits of a potential acquisition and subsequent steps to remedy that omission may give rise to a claim for negligence; but it cannot support a claim for securities fraud.").

Plaintiffs' second allegation contends that the Individual Defendants knew, but did not disclose, that revenues would decline because new York state does not allow fee-splitting with non-doctors or corporations. Had Defendants conducted adequate due diligence, Plaintiffs claim, the Individual Defendants would have discovered and disclosed the existence of these purported illegal agreements. Plaintiffs ignore that Defendants did, in fact, warn investors that such "anti-kickback" or "fee-splitting" laws could adversely affect PRG's business operations. In a May 14, 1996 prospectus, for example, Defendants disclosed under the heading "Government Regulation" that "[s]everal states ... have adopted laws similar to the "anti-kickback" and "anti-referral" laws that cover patients in private programs as well as government programs." Def. PRG's App. "Tab D" at 11-12. This paragraph warns investors that "[a] determination of liability under any such laws could have a material adverse affect on PRG." *Id.* at 12. Defendants included similar or identical disclosures in prospectuses dated June 23, 1995, *id.* "Tab A" at 8; February 14, 1996, *id.* "Tab B" at 11-12; July 25, 1996, *id.* "Tab E" at 7; August 26, 1996, *id.* "Tab F" at 5; and January 2, 1997, *id.* "Tab G" at 7. The existence of these disclosures in no fewer than six prospectuses filed with the SEC substantially undermines any inference of scienter based on the these purportedly illegal practice management agreements. *See Lovelace,* 78 F.3d at 1019-20 (finding no inference of scienter after noting that defendants disclosed certain risk factors in prospectuses filed with the SEC).

b. Allegations Related to PRG's Management Information and Accounting Systems

***12** Plaintiffs next allege that PRG's "sophisticated" management information systems and "strong operational and financial controls" were inadequate to monitor existing operations and to integrate the acquired practices. Paragraph 63(c) asserts

> The Company could not generate accurate monthly financial statements for the practices it supposedly managed, which resulted in persistent disputes with them, including their refusal to pay disputed receivables to PRG.

Third Am. Compl. ¶ 63(c). Paragraph 63(e) further alleges that

> PRG's accounting department was overwhelmed--it lacked adequate personnel, systems, or controls to monitor existing operations, let alone cope with the increasing number of acquisitions. As a result, the Company could not generate accurate financial statements for its individual practices or the parent public company.

Id. ¶ 63(e). These allegations are framed in conclusory terms and are based on hindsight, and therefore do not raise a strong inference of fraud. The complaint fails to identify with particularity which monthly financial statements were inaccurate, how they were inaccurate, the number or nature of the inaccuracies, or when, if ever, these financial statements were disputed. Nor does the complaint specify which individual practices disputed their financial statements or what particular statements were in dispute. The complaint does not even specify, except in conclusory terms, that any of the Individual Defendants knew of these inaccuracies or when they became aware of them. Plaintiffs argue that PRG's internal accounting problems were so pervasive and severe the Individual Defendants were

reckless in not knowing about them, yet Plaintiffs identify only one practice that experienced problems with its payroll. Without a stronger factual predicate, the court cannot, based on so few well-pleaded factual allegations, find strong circumstantial evidence of reckless conduct that would give rise to an actionable inference of fraud. Finally, even assuming that PRG experienced accounting and information failures, "the securities laws simply do not guarantee sound business practices" *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 361 (1st Cir.1994) (quoting *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990).

c. Allegations Relating to PRG's Failure to Follow GAAP

Finally, Plaintiffs assert that PRG and the Individual Defendants violated generally accepted accounting principles and relevant securities and exchange regulations. Specifically, paragraph 98 alleges:

> In order to overstate PRG's revenues, net income, and EPS during the Class Period, the Individual Defendants caused the Company to violate GAAP and SEC rules by improperly recognizing revenue on management services for which it could not reasonably expect ever be paid due to its woefully inadequate internal controls, which made collection improbable. PRG failed to adequately accrue reserves for its uncollectible accounts receivable and receivables from affiliates, and failed to account for financial impairment caused by the over- valuation of EquiMed when it became aware of the need to write off EquiMed's assets.
> ***13** Third Am. Compl. ¶ 98.

As a general rule, "the mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter. The party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information." *Lovelace*, 78 F.3d at 1020 (quoting *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir.1990); *see also Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir.1999) ("The failure to follow GAAP is, by itself, insufficient to state a securities fraud claim."). In *Lemmer*, this court recognized that GAAP requirements "often require the substantial application of judgment to the totality of circumstances." *Lemmer*, 2001 WL 1112577, at *10. "The term 'generally acceptable accounting procedures' ... encompass[es] a wide range of acceptable procedures, such that 'an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable procedures when that accountant prepares a financial statement." *Lovelace*, 78 F.3d at 1021 (citations omitted).

Plaintiffs allege that Defendants improperly recognized revenue from management services for which it could not reasonably expect to recover. Third Am. Compl. ¶ 98. In similar fashion, Plaintiffs contend that PRG failed to accrue adequate reserves for its uncollectible accounts receivable and receivables from affiliates. *Id.* Plaintiffs fail to state "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-(b)(2). To establish a strong inference of scienter, plaintiffs must provide additional facts that describe what accounts receivable were uncollectible, when they became due, why they are presently uncollectible, and perhaps most importantly, why the Individual Defendants knew that they could not expect to recover on the accounts at the time such statements or omissions were made.

Plaintiffs also fail to state with any particularity what percentage of the accounts were uncollectible, what proportion of accounts were uncollectible in relation to all of its accounts, what reserves were allocated, or what reserves Plaintiffs believe should have been taken. They also have not alleged the "significance of the overstated receivables in relation to [the company's] total financial picture." *Coates II*, 55 F.Supp.2d at 639 (holding inadequate under Rule 9(b) pleading that alleged defendants overstated receivables but did not provide facts that support overstatement was material); *see also Shushany v. Allwaste, Inc.*, 992 F.2d 517, 522 (5th Cir.1993) (holding inadequate under Rule 9(b) complaint that did not specify whether accounting adjustments were material); *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir.1992) (finding inadequate allegations concerning reserve allocations where plaintiff failed to allege what reserves were or what they should have been). Absent greater particularity, the court cannot determine whether these alleged GAAP violations constitute "an extreme departure from the standards of ordinary care." *Nathenson*, 267 F.3d at 408. As pleaded, Plaintiffs' allegations in this regard do not support a

strong inference of fraudulent intent.

*14 In its current form, Plaintiffs' complaint pleads fraud by hindsight, suggesting that Defendants "must have" known that certain accounts were uncollectible and that reserves should have been accrued. As evidence of scienter, Plaintiffs point to comments made during a meeting in late November 1997 by Defendant D'Amico. In this meeting, Plaintiffs allege that D'Amico admitted, *inter alia,* that PRG lacked the necessary accounting systems to generate reliable Form 10-Q's, that PRG could not add more practices because of internal control problems, and that a number of the acquired practices experienced diminishing bottom lines. Third Am. Compl. ¶ 93. Plaintiffs bolster D'Amico's "admissions" with a December 1997 news article and with comments made in mid-January by PRG's new President and Chief Operating Officer, Peter G. Dorflinger. Third Am. Compl. ¶¶ 94, 95. All of these "admissions" post date the class period. To be sure, the statements and "admissions" made by D'Amico, Dorflinger, and other Board members indicate that PRG and some of the Individual Defendants were aware of a number of accounting inaccuracies by late November 1997 and early 1998; however, contrary to what Plaintiffs allege, none of these comments suggests that the Individual Defendants knew or recklessly disregarded PRG's accounting errors at the time these "errors" were made.

Plaintiffs also allege that PRG failed to account for the financial impairment caused by its overvaluation of EquiMed. The overvaluation resulted in a one-time $31.75 million charge for uncollectible accounts receivable and practice closings and created a $18 million loss in the third quarter of 1997. Plaintiffs maintain that PRG and the Individual Defendants knew by at least June 30 of the second quarter of 1997 that EquiMed's assets were overstated. As evidence of Defendants' scienter, Plaintiffs point to a $45 million counterclaim filed in June 1997 by PRG against EquiMed in an arbitration proceeding. PRG announced these counterclaims in a June 17, 1997 press release stating, in relevant part, that PRG's counterclaims "include, among others, breach of representation and warranties, fraud and conversion." Def. PRG's App. "Tab P"; *see also* Third Am. Compl. ¶ 85. Plaintiffs contend that PRG should have taken the impairment as the time it became aware of the need, or the latest, sometime in the second quarter of 1997.

The timing of a write-off alone, however, cannot support an inference of fraud. *See Coates III,* 100 F.Supp.2d at 429. Instead, Plaintiffs must allege that "the need to write-down ... was 'so apparent' to [the defendant] before the announcement, that a failure to take an earlier write-down amounts to fraud." *Id.* (internal citations omitted). Although PRG did not take a write- down in the second quarter of 1997, the company did disclose this information to the market when it became of aware that an accounting adjustment might be necessary. This disclosure substantially undermines any strong inference of fraud based on the impairment PRG later deemed necessary. The court rejects the opportunity to find a strong inference of fraud based on these allegations, particularly in light of Defendants' disclosure.

*15 Finally, Plaintiffs allege that the magnitude of the accounting errors creates an inference of fraud.

> Paragraph 110, for example, estimate the extent of PRG's misstated financial results, related to the Company's improper revenue recognition and failure to adequately reserve for uncollectible accounts receivables, was to misstate its 1996 operating income (excluding merger charges) by a minimum of $1 million for Q1, $1.3 million for Q2, $1.9 million for Q3, and $3.0 million for Q4, and by a minimum of $4.0 million, and $6.0 million of Q1 and Q2 1997 respectively. PRG's 1995 results were similarly misstated due its [sic] improper revenue recognition on uncollectible reserves.

Third Am. Compl. ¶ 110. To the extent these estimations are based on information and belief, Plaintiffs nowhere in the complaint "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u- 4(b)(1). Thus, the court cannot determine from the face of the complaint how these estimations were made, whether they are reasonable, or whether they support an inference of fraud.

d. Allegations Related to Andersen's Intentional Misconduct and Severe Recklessness

Plaintiffs maintain that Andersen possessed actual knowledge or recklessly disregarded that PRG's 1995 and 1996 year-end, and 1997 quarterly

financial statements were false and misleading. As evidence of Andersen's scienter, Plaintiffs point to the same facts they claim support an inference of fraud against PRG and the Individual Defendants; namely, that (1) Andersen knew, but disregarded, that PRG did not conduct adequate due diligence on a number of its acquisitions, (2) Andersen knew, and disregarded, PRG's lack of adequate internal controls, and finally, that (3) Andersen violated GAAS and GAAP by (i) recognizing improperly revenue that would not be realized, (ii) failing to accrue adequate reserves for the uncollectible receivables, and (iii) failing to account for the financial impairment of EquiMed. Plaintiffs further allege that the magnitude of fraud supports a strong inference of scienter.

In support of these general allegations, Plaintiffs do not distinguish those facts they allege support an inference of fraud against PRG with those facts that support such an inference against Andersen. Instead, the paragraphs that contain allegations regarding PRG and the Individual Defendants' scienter also contain boilerplate averments that Andersen "intentionally or recklessly concealed" certain "true facts ... which were 'red flags." ' *See, e.g.*, Third Am. Compl. ¶ 63. These "red flags" include the same general and conclusory allegations that the court, as explained above, determined were insufficient to support an inference of fraud on the part of PRG and the Individual Defendants. [FN11] These allegations do not support any greater inference of fraud when alleged against Andersen alone.

> FN11. Specifically, these "red flags" include allegations that PRG never obtained EquiMed's complete financial statements, Third Am. Compl. ¶ 63(a), that EquiMed could not generate monthly or quarterly financial reports, *id.*, that PRG did not generate accurate monthly financial statements for its affiliated practices, *id.* ¶ 63(c), that the acquired practices refused to pay disputed receivables, *id.*, that PRG lacked the personnel and infrastructure required to integrate its acquisitions, *id.* ¶ 63(j), and that PRG's core revenue growth was slowing, which put pressure on its ability to achieve EPS growth, *id.* ¶ 63(o), among others.

Moreover, nowhere does the complaint plead with sufficient particularity facts that support how Andersen knew or became aware of these "red flags." Plaintiffs generally base Andersen's knowledge on its participation in "audits and reviews," "consulting services," and "its review of [PRG's] prospectuses and other SEC filings." Third Am. Compl. ¶ 63. Plaintiffs also claim that Andersen was aware of PRG's internal control deficiencies because Andersen "set up" PRG's information and accounting systems, *id.* ¶ 118, and because Andersen advised PRG of weaknesses in PRG's internal control structures in connection with its year 1997 audit, *id.* ¶ 97. The complaint does not, however, match any of these general averments with any particularized facts that support the claim that Andersen knew or recklessly disregarded this information at the time it conducted its audits and quarterly reviews. As pleaded, the complaint generally avers knowledge or severe recklessness with respect to all of the Defendants, and asks this court to assume, based on conclusory averments of fact, that Andersen participated in a scheme to defraud investors. Plaintiffs cannot rely on Andersen's eventual resignation as the PRG's auditor to support an inference of fraud. That Andersen later became aware of, and ultimately disclosed, PRG's internal accounting control problems does not support the inference that Andersen had knowledge or recklessly disregarded that information earlier.

***16** Taken together, Plaintiff's allegations do not raise a strong inference of fraudulent intent and therefore do not adequately plead scienter with respect to any Defendants. 15 U.S.C. §§ 78u-4(b)(2); *Robertson*, 32 F.Supp.2d at 477. Plaintiffs criticize the piecemeal examination of its claims, however, the PSLRA "does not permit the Court to look at the broad picture to determine if Plaintiff has properly plead its claim." *Lain v. Evans*, 123 F.Supp.2d 344, 348 (N.D.Tex.2000). Accordingly, all Defendants are entitled to dismissal of the § 10(b) and Rule 10b-5 claims against them in light of Plaintiffs' failure to plead sufficient facts that establish a strong inference of the required state of mind. 15 U.S.C. § 78u-4(b)(3)(A).

IV. Plaintiffs' Remaining Claims

Plaintiffs' also allege violations of section 20(a) of the Exchange Act. This section defines controlling person liability, providing that:

[e]very person who, directly or indirectly, controls any person liable under any provision of this

> chapter ... shall also be liable jointly and severally with and to the same extent as such controlled person....

15 U.S.C. 78t(a). Where a primary violation by the "controlled person" has not been adequately pleaded, the court should also dismiss a section 20(a) claim. *See Coates I,* 26 F.Supp.2d at 923. Because Plaintiffs have failed to plead a violations of section 10(b) and Rule 10b-5, Plaintiffs' section 20(a) claim must also be dismissed. *See Coates II,* 55 F.Supp.2 d at 645.

V. Conclusion

For the reasons stated above, the court concludes that Plaintiffs have failed to plead fraud with sufficient particularly to state a claim under the federal securities laws. The court also concludes that Plaintiffs have not adequately alleged scienter with respect to any Defendants.

Plaintiffs have requested the court to allow further amendment of their Complaint if it believes that they have not stated a claim upon which relief can be granted. The decision to allow amendment of the pleadings is within the sound discretion of the district court. *Norman v. Apache Corp.,* 19 F.3d 1017, 1021 (5th Cir.1994). In determining whether to allow an amendment of the pleadings, the court considers the following: undue delay in the proceedings, undue prejudice to the opposing parties, timeliness of the amendment, and futility of the amendment. *See Foman v. Davis,* 371 U.S. 178, 182 (1962); *Chitimacha Tribe of Louisiana v. Harry L. Laws Co., Inc.,* 690 F.2d 1157, 1163 (5th Cir.1982).

The court concludes that Plaintiffs have stated their best case after four bites at the apple. As the Fifth Circuit has stated, "[a]t some point, a court must decide that a plaintiff has had fair opportunity to make his case; if, after that time, a cause of action has not been established, the court should finally dismiss the suit." *Jacquez v. Procunier,* 801 F.2d 789, 792-93 (5th Cir.1986). The court believes that permitting a fifth pleading attempt would be an inefficient use of the parties' and the court's resources, would cause unnecessary and undue delay, and would be futile. For the reasons stated herein, Plaintiffs' claims are dismissed with prejudice. Judgment will be entered by separate document as required by Fed.R.Civ.P. 58.

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Only the Westlaw citation is currently available.

United States District Court, N.D. Texas, Dallas Division.

Allan ZISHKA, et al., On Behalf of Themselves and All Others Similarly Situated, Plaintiffs,
v.
AMERICAN PAD & PAPER COMPANY, et al. Defendants.

No. Civ.A.3:98-CV-0660-M.

Sept. 28, 2001.

ORDER

LYNN, J.

*1 Having considered the Motions to Dismiss filed by the Defendants on December 14, 2000, the Plaintiffs' Responses, the Defendants' Replies, supporting appendices, the applicable authorities, and the arguments at a hearing held on April 25, 2001, the Court is of the opinion that the Motions to Dismiss should be GRANTED in part, and DENIED in part.

On September 13, 2000, this Court entered its Memorandum Opinion and Order, granting the Defendants' Motions to Dismiss, but permitting the Plaintiffs an opportunity to replead. They did so by filing an Amended Complaint on October 30, 2000. Defendants again moved to dismiss.

The Court concludes that a limited number of the Plaintiffs' claims are sufficient under the Private Securities Litigation Reform Act. Most are not. The Amended Complaint is virtually entirely comprised of allegations of fraud- by-hindsight and is premised on vague statements of optimism by American Pad and Paper Company ("Ampad") and its executives. Such allegations are not sufficient under the Private Securities Litigation Reform Act ("PSLRA") or this Court's Order.

The Court will begin its analysis with the Bain Defendants--Bain Venture Capital and Defendants Wolpow, Gay & Lavine--as to whom the Plaintiffs' allegations are made only under Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). The allegations against the Bain Defendants are legally insufficient. Plaintiffs plead only that because the Bain investment funds owned 38%-50% of the stock of Ampad, and thus had the power to, and did, place three persons on the Ampad Board who were affiliated with Bain (Wolpow, Gay and Lavine), Bain and Wolpow, Gay, and Lavine are liable as control persons under Section 20(a). The Court holds that the Plaintiffs have not pleaded sufficient exercise of power and control by the Bain Defendants as to the challenged acts. Status alone as to persons not involved in day to day management is legally insufficient to support a Section 20(a) claim. *See Dartley v. Ergobilt Inc., et al.*, No. 3:98-CV-1442-M (N.D.Tex. Mar. 29, 2001) (Lynn, J.). *See generally, Abbott v. Equity Group, Inc.*, 2 F.3d 613, 615 n. 15 (5 th Cir.1993), *cert. denied*, 510 U.S. 1177 (1994); *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496 (5 th Cir.1990); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5 th Cir.1981). Since Plaintiffs were given one additional opportunity to replead, and have not done so satisfactorily with respect to the Bain Defendants, the claims against the Bain Defendants are dismissed with prejudice.

The Court also dismisses with prejudice those claims regarding the LIFO reserves (Amended Complaint ¶¶ 28-31) except for those relating to rising costs of paper in late 1996 and early 1997. In the Court's view, the Amended Complaint adequately details the contention that the Defendants knew that during the last quarter of 1996 and the first quarter of 1997, paper prices were rising, but Ampad intentionally delayed adjusting the reserve. All other allegations regarding the LIFO reserves are dismissed with prejudice.

*2 Plaintiffs also adequately allege claims relating to Ampad's pricing policies providing protection against rising paper prices. The risk disclosures in Ampad's filings are insufficient to outweigh the apparently unsubstantiated and seemingly unjustified statements that Ampad had implemented a pricing strategy that would protect it in an era of rising prices. When prices rose, profits suffered. There is nothing before the Court explaining what objective facts justified the repeated and persistent trumpeting of the Company's pricing policy as a protection if paper prices began to rise.

The claims of improper revenue recognition and problems involving returns of goods (¶¶ 26-27 of Amended Complaint) are legally insufficient. Plaintiffs do not provide sufficient detail to support those allegations, such as describing specific transactions in which there was improper recognition, the materiality of such transactions and any restatements resulting, including any alleged impact on the December 1997 charges. The claimed deficiencies in statements regarding returns and discounts or rebates are similarly defective. The risk disclosures in the prospectus clearly note that reserves and rebates will affect profitability. Reserves for returns and rebates were established and disclosed. The Complaint does not allege that the reserves were false nor does it allege the volume of returns, the materiality of same nor the impact on any restatement. The Court is not persuaded by the Plaintiffs' claims that the PSLRA permits Plaintiffs to impute knowledge to senior executives of what appear to be some plant-specific problems.

The allegations regarding the Williamhouse acquisition and the Williamhouse reporting system are inadequate and do not comply with this Court's Order directing that Plaintiffs set out when the Defendants discovered the problem, when they attempted to remedy it (which is not satisfied by a vague statement of a two year period), when they learned the attempted remedy was unsuccessful, and its dollar impact. These omissions render the allegations factually deficient.

Plaintiffs' allegations regarding introduction of new products, the effect of consolidation, the integration (or lack thereof) of acquisitions, and the failure to make new acquisitions are also fatally deficient. Plaintiffs identify no statement that a particular new product would be introduced at a particular time. The Shade and Williamhouse acquisitions undeniably brought product to Ampad that it did not sell previously, and they were acquisitions during the class period. Ampad guaranteed no particular acquisitions on any certain schedule and also disclosed that the likely impact on Ampad of competition and consolidation was uncertain. These claims all fail for lack of detail, for lack of factual support, and due to the existence of clear risk disclosures in the prospectus and in later Ampad press releases.

Finally, Plaintiffs' Amended Complaint is wholly deficient in improperly attributing analysts' projections of earnings per share to individual defendants, when it is not alleged that the defendants made such projections, and in charging them with liability for miscellaneous generalized GAAP allegations (¶ 33). Such contentions do not satisfy the PSLRA.

***3** As to Benson and McAleer, scienter is not properly pleaded. One cannot divine a strong inference of fraudulent intent as to them from the Amended Complaint. Therefore, the claims against them are DISMISSED with prejudice.

As to Hanson and Gard, the few remaining allegations of false statements regarding Ampad's pricing policy and failure to disclose the need for an adjustment to the LIFO reserve are adequately stated, and scienter as to them is sufficiently alleged by their stock transactions. All other claims in the Amended Complaint are DISMISSED with prejudice. Plaintiffs are directed to submit within twenty days a new complaint striking the allegations dismissed herein, and adding no others.

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United States District Court, N.D. Texas, Dallas Division.

Allan ZISHKA, et al., on Behalf of Themselves and All Others Similarly Situated, Plaintiffs,
v.
AMERICAN PAD & PAPER COMPANY, et al., Defendants.

No. CIV.A. 398CV0660M.

Dec. 20, 2001.

MEMORANDUM OPINION AND ORDER

LYNN, District J.

***1** On September 28, 2001, the Court entered an order dismissing Plaintiffs' claims against all Defendants [FN1] except Charles G. Hanson III, American Pad & Paper Company's ("Ampad's") Chief Executive Officer and Chairman of its Board of Directors, and Russell M. Gard, Ampad's Chief Operating Officer and member of its Board. [FN2] Although the Court found that Plaintiffs improperly pleaded their claims against all of the other Defendants, it found that Plaintiffs had properly pleaded the elements required for claims under section 10(b) and 20(a) of the Securities Exchange Act of 1934 and under SEC Rule 10b-5 as to Hanson and Gard. The central premise of the Court's finding was that Plaintiffs had sufficiently alleged scienter as to Hanson and Gard through motive and opportunity pleading. [FN3]

FN1. Named Defendants in Plaintiffs' First Amended Complaint, filed on October 30, 2000, included Charles G. Hanson III, Russell M. Gard, Gregory M. Benson, Kevin McAleer, Robert C. Gay, Jonathan S. Lavine, Marc B. Wolpow, and Bain Capital.

FN2. The Court entered the September 28, 2001 Order on Defendants' Second Motion to Dismiss, filed on December 14, 2000, which was directed toward Plaintiffs' First Amended Complaint. After Plaintiffs first filed suit in March 1998, Defendants had filed their original Motion to Dismiss, which the Court granted in its Order of September 13, 2000. However, the Court gave Plaintiffs an opportunity to replead their claims in accordance with the specifications provided in the Court's Order. Plaintiffs filed their First Amended Complaint on October 30, 2000, in response to this Order.

FN3. Plaintiffs alleged that these Defendants' status as company insiders, along with their sale of 20% of their stock five weeks before Ampad's stock price dropped significantly, showed motive and opportunity, which the Court had previously held is sufficient to constitute the requisite scienter for a 10(b)/10b-5 claim under the Private Securities Litigation Reform Act (PSLRA). *See* Order of September 13, 2000 ("[T]he Court concludes that scienter can be based upon allegations of 'motive and opportunity' as alternative to allegations of 'conscious behavior or severe recklessness,' thereby following the lead of most of the other courts in this district.").

Contemporaneous with the entry of the Court's September 28, 2001 Order, the Fifth Circuit decided *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir.2001), [FN4] and clarified Fifth Circuit law on scienter in section 10(b) Securities Exchange Act cases. In light of this decision, on October 15, 2001, Defendants Gard and Hanson filed a Motion for Reconsideration of the Court's September 28, 2001 Order. In the Motion, Defendants argue that *Nathenson* rejects motive and opportunity pleading as sufficient to constitute the requisite allegations of scienter under the PSLRA and requires the Court to find Plaintiffs have insufficiently pleaded scienter as to both Hanson and Gard. [FN5] After reviewing Defendants' Motion, along with the Response and Reply thereto, the Court is of the opinion that it should GRANT the Motion for Reconsideration, and amend its Order of September 28, 2001 to dismiss Plaintiffs' allegations against Hanson and Gard, for the reasons stated below.

FN4. *Nathenson* was released on September 25, 2001.

FN5. In their Motion for Reconsideration, Defendants also urge the Court to reconsider its finding that Plaintiffs sufficiently alleged fraud in Ampad's failure to adjust its LIFO reserves in response to rising paper prices in late 1996 and early

1997 and in Ampad's statements regarding the protection its pricing policies provided against rising paper prices. Given its finding that *Nathenson* requires dismissal of Plaintiffs' allegations against Hanson and Gard, the only remaining Defendants in the suit, the Court determines it is not necessary to reach these arguments.

Nathenson was a class action against Zonagen and its officers, directors, and major shareholders for violations of 10(b) and 20(a) of the 1934 Act and Rule 10b-5. The plaintiffs alleged that, during the class period, the defendants "engaged in a scheme to defraud their shareholders by issuing a series of public misrepresentations about two of Zonagen's potential products in order to inflate artificially the value of Zonagen's stock and sell $67.5 million in stock in July 1997 at an inflated price." *Id.* at 404. The defendants moved to dismiss the claims, arguing, inter alia, that the plaintiffs failed to allege facts sufficient to constitute scienter, an element required for causes of action asserted under 10(b) and 10b-5. *See id.* at 405-12.

In determining whether dismissal was an appropriate remedy in this case, the *Nathenson* court first observed that,

[i]n order to state a claim under section 10(b) ... and Rule 10b-5, a plaintiff must allege, in connection with the purchase or sale of securities, "(1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which plaintiff relied (5) that proximately caused [the plaintiff's] injury."

*2 *Id.* at 406-07 (quoting *Tuchman v. DSC Comm. Corp.*, 14 F.3d 1061, 1067 (5th Cir.1994)). It then noted that, under the PSLRA, "a plaintiff alleging a section 10(b)/Rule 10b-5 claim must now plead specific facts giving rise to a 'strong inference' of scienter ." *Id.* at 407. The *Nathenson* court continued by explaining that allegations of recklessness serve to satisfy the scienter requirement, with the proper standard for recklessness being "severe recklessness," which "resembles a slightly lesser species of intentional misconduct." *Id.* at 408. [FN6] It then engaged the question of what "pattern of facts ... may be pleaded in order to create the 'strong inference' of either intentional misconduct or severe recklessness." *Id.* at 409. The court explained,

FN6. It rejected the Ninth Circuit's holding that "recklessness suffices to meet the substantive scienter requirement *only* if it rises to the level of 'deliberate recklessness.' " *Id.* at 409 (quoting *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975-77 (9th Cir.1999)).

[b]efore Congress passed the PSLRA, the Second Circuit announced two means by which a plaintiff could plead facts that would create a strong inference of scienter: the plaintiff could either (1) allege facts to show that a defendant had both motive and opportunity to commit fraud, or (2) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

Id. (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir.1994)). The *Nathenson* court found, however, that the passage of the PSLRA rendered motive and opportunity pleading alone insufficient for purposes of alleging scienter. *See id.* at 410. It surveyed various circuits' approaches to the question of whether motive and opportunity pleading is allowed under the PSLRA, finding that

[t]he most sensible approach appears to us to be the one first generally articulated by the Sixth Circuit in *Comshare* [*In re Comshare Sec. Litig.*, 183 F.3d 542, 548-49 (6th Cir.1999)]. The *Comshare* Court held that scienter can be alleged by pleading facts giving rise to a strong inference of recklessness or conscious misconduct, but declined to hold that allegations of motive and opportunity, "standing alone," meet the pleading requirement. The Court made the entirely accurate observation that "evidence of a defendant's motive and opportunity to commit securities fraud does not constitute 'scienter' for the purposes of [section 10(b)] or Rule 10b-5 liability." Instead, the Court stated that motive and opportunity could be "relevant" to pleading scienter and "may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct."

Id. at 410-11 (citations omitted). Based on the *Comshare* court's approach, the Fifth Circuit concluded that "[w]hat must be alleged is not motive and opportunity as such[,] but particularized facts giving rise to a strong inference of scienter." *Id.* at 412.

Based on these conclusions, the *Nathenson* court held that the plaintiffs' allegations of motive and opportunity were insufficient to constitute scienter as to one of the defendants in the case, an outside

director. *See id.* at 420. The court explained,

> ***3** [t]he only allegation of officer or director trading is that Blasnik, an outside director, sold 62,000 shares on April 25, 1996, at $9.94 a share and 80,000 shares between January 31, 1997, and February 3, 1997, at prices between $16.03 and $16.25 a share. We agree with the district court that these allegations are insufficient. The total sales amounted to about 18.5% of the shares attributable to Blasnik. As to the April 25, 1996[ ] sale, it took place more than a month after the stock began its mid-March 1996 several month steady decline, was at a price well below that at the beginning and at the end of the class period, and is less than a third of what the shares were traded for in the July 1997 public offering and less than a fourth of the October 1997 high. As to the sales between January 31, 1997, and February 3, 1997, we note ... that "they took place long after [certain alleged misstatements were made on November 13, 1996] and long before [others were made on May 27, 1997]."

Id. at 420. The court thus characterized the plaintiffs' allegations as follows: " 'At most plaintiffs allege that one outside director sold a fraction of his holdings at times that were unrelated to any Company announcements and at prices that were far below that which he could have obtained by selling a few weeks earlier or later." ' *Id.* The Fifth Circuit found that such contentions do not give rise to a strong inference of scienter: " 'Insider' trading must be 'unusual' to have meaningful probative value. Sales such as Blasnik's which are 'so inauspiciously timed' do not meet this test. Moreover, '[t]he fact that the other defendants did not sell their shares during the relevant class period undermines plaintiffs' claim." ' *Id.* at 420-21.

Defendants argue that the *Nathenson* court's holding that motive and opportunity cannot alone satisfy the scienter requirement, along with its application to Blasnik's circumstances, "compel[ ] the conclusion that the stock sales" made by Defendants Gard and Hanson "are not probative of scienter." Defendants' Reply to Motion for Reconsideration at 3. Defendants list the following as reasons for this conclusion:

1. In both *Nathenson* and *Zishka*, "the sales occurred when the price was approximately half of its class-period high."
2. In both cases, "the sales occurred at prices far below those" the defendants could have obtained by selling the stock a few weeks earlier.
3. In both cases, "the sales took place weeks *after* the stock price began to decline."
4. In both cases, "the inference of scienter is undercut by the fact that other insiders did not sell during the same period."
5. In both cases, the defendants sold only a fraction of their shares--Gard and Hanson sold 20%, while Blasnik sold 18.5%.
6. In both cases, the sales "took place long after dissemination of the allegedly false statements that purportedly animated the sales"-Defendants Hanson and Gard sold "eleven months after allegedly manipulating the LIFO reserves, almost three months after allegedly misrepresenting the pricing policy, two months after making the September 1997 disclosure, and three weeks after disclosing the 3rd Q 1997 results."

***4** The Court finds merit in these contentions by Defendants. Defendants' stock sales, by themselves, appear insufficient to constitute scienter under the higher, "severe recklessness" standard. The trading occurred at a relatively inauspicious time-only two months after the stock price dropped to an all-time low of around $11 per share. [FN7] Hanson and Gard only sold 20% of their shares, and no other officers or directors sold at any time during the class period. Although this was sufficient to constitute scienter through motive and opportunity pleading, it fails under *Nathenson* 's pleading requirements.

> FN7. It had been at almost $25 per share immediately prior to the drop.

Plaintiffs respond to Defendants' arguments by stating that, even under the standard for scienter articulated in *Nathenson*, the allegations within their Amended Complaint suffice to satisfy the element. The *Nathenson* court defined severe recklessness as encompassing "highly unreasonable omissions or misrepresentations ... that present a danger of misleading buyers or sellers which is either known to the defendant or so obvious that the defendant must have been aware if it." 267 F.3d at 408. Thus, Plaintiffs argue that Defendants' insider trading, coupled with other events, such as the LIFO-reserve accounting irregularities and Defendants' false or misleading statements about pricing policies, give rise to an inference of severe recklessness.

Plaintiffs argue that a separate section within *Nathenson* dictates such a finding. The *Nathenson* court found that plaintiffs had pleaded the requisite scienter with respect to Podolski, the CEO of Zonagen, due to certain statements he made that allowed for a strong inference of scienter on his part as to certain misrepresentations made by the company. In its SEC filings and in press releases, Zonagen claimed to have acquired the rights to a patent covering the company's leading product, Vasomax, an oral treatment for male erectile dysfunction. *See id.* at 424-25. In reality, the company did not own a patent covering the product. *See id.* Podolski, the CEO, was quoted in one of the press releases as stating that the approval of the patent was a "crucial event." *Id.* at 425. Additionally, he was quoted in other press releases and in an article that appeared in *Fortune* magazine as conceding that "[y]ou can say today that no patent specifically covers Vasomax," although he claimed that "the company's issued patent 'broadly covers' the drug." *Id.* The court found these statements, along with the facts that Vasomax was basically the only product Zonagen had and it was important to the company whether it owned a patent that covered Vasomax, satisfied the scienter requirement for both Podolski and Zonagen. *See id.* at 425.

Plaintiffs construe this holding as requiring this Court to find that high- level officers such as Gard and Hanson can be presumed to have had knowledge of facts or events critical to a company's business, including knowledge of misstatements made by the company. This Court finds that it should not adopt this interpretation of the case, however. Nowhere does the *Nathenson* court advocate a presumption-of-knowledge doctrine for corporate officers. Instead, the court posits that, "normally[,] an officer's position with a company does *not* suffice to create an inference of scienter." *Id.* at 424 (emphasis added). [FN8] The *Nathenson* court's finding of scienter instead rested in large part on Podolski's own statements about the patent which clearly demonstrated scienter and on the court's recognition of the overarching importance of the Vasomax patent to the continuing viability of Zonagen.

FN8. The court also noted: "[A]llegations that corporate officers and directors would benefit from enhancing the value of their stock and/or stock options and that the corporation would benefit by receiving more for its shares ... are ... insufficient to support a strong inference of scienter." *Id.* at 420.

***5** Hanson and Gard did not leave such a smoking gun for Plaintiffs. They are not quoted in *Fortune* magazine as admitting they knew the statements issued by Ampad were untrue. Furthermore, the Court rejected Plaintiffs' presumption- of-knowledge argument in its September 28, 2001 Order, holding that such assertions, which were also made against Defendants Benson and McAleer (former Chief Financial Officers of Ampad) were insufficient, even under the motive and opportunity pleading rules, to constitute scienter. Thus, the Court refuses to read *Nathenson* as requiring the Court to presume that Hanson and Gard had knowledge of fraud simply because of their position as company insiders. Additionally, the Court finds Plaintiffs' allegations of Defendants' stock transactions do not give rise to the requisite scienter under *Nathenson*. Therefore, the Court GRANTS Defendants' Motion for Reconsideration, and hereby amends its September 28, 2001 Order to dismiss Hanson and Gard as Defendants. Because Hanson and Gard were the only remaining Defendants in this case, there are no other matters in controversy between the parties and the Clerk is directed to close the case.

SO ORDERED.

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